VINGS AND LOAN INSURANCE ECAPITALIZATION ACT (H.R. 27)

HEARINGS

BEFORE THE

BANKING, FINANCE AND
BAN AFFAIRS
REPRESENTATIVES

NDREDTH CONGRESS

FIRST SESSION

ON

H.R. 27

PROVISION OF ADDITIONAL FINANCIAL RE-
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HEARINGS

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

ONE-HUNDREDTH CONGRESS

FIRST SESSION

ON

H.R. 27

A BILL TO FACILITATE THE PROVISION OF ADDITIONAL FINANCIAL RESOURCES TO THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

JANUARY 21 and 22, 1987

Printed for the use of the Committee on Banking, Finance and Urban Affairs

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FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION RECAPITALIZATION ACT OF 1987 (H.R. 27)

Wednesday, January 21, 1987

House of Representatives,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain [chairman of the committee] presiding.

Present: Chairman St Germain, Representatives Gonzalez, Neal, Hubbard, LaFalce, Vento, Barnard, Frank, Lehman, Kaptur, Erdreich, Carper, Torres, Kleczka, Nelson, Patterson, McMillen, Kennedy, Flake, Mfume, Price, Wylie, McKinney, Shumway, Parris, McCollum, Wortley, Reukema, Dreier, Bartlett, Roth, McCandless, McMillan, Saxton, Swindall, Saiki, and Bunning.

The Chairman. The committee will come to order.

Before we fully begin this morning's hearing and our opening statements, I would like to welcome our new Members, and introduce our new Members. On the Democratic side we have six new faces to brighten the committee and they are all down on the front row.

From Spartanburg, SC—and we go by seniority as chosen by the committee, the Democratic Steering and Policy Committee, so we are not doing it alphabetically, but rather by seniority as came out of the Steering and Policy Committee. From Spartanburg, SC, Elizabeth J. Patterson. She has served on the City Council and in the South Carolina legislature before her election last fall. A number of us have a fond memory of her late father, Olin Johnston, who served with distinction in the United States Senate.

We welcome you, Ms. Patterson.

Next in seniority among the new Members is Tom McMillen, whose Fourth Maryland Congressional District lies just a few miles from the Capitol. Anyone who has followed basketball in this area or in the National Basketball Association has seen a lot of Tom McMillen. But Tom has an equal number of trophies in the academic world, including a stint as a Rhodes Scholar.

Tom, we welcome you aboard as well.

Every now and then someone comes along who truly fits the cliche, "He needs no introduction." Certainly that applies to my neighbor from Boston, Joe Kennedy. Not only is Joe Kennedy the son of a former U.S. Senator and Attorney General, the nephew of

a former President, and the nephew of a sitting U.S. Senator, but he lists among his constituents Thomas P. (Tip) O'Neill.

We welcome you as well, Joe.

We increase our representation—well, we will have to wait for him to arrive.

The committee will continue to have an important and strong presence from Baltimore in Kweisi Mfume who takes the seat vacated by our long-term colleague, Parren Mitchell. Long prominent in broadcasting in Baltimore, Mr. Mfume has been on the Baltimore City Council since 1979 and lends great strength to this committee's representation for its expertise on urban problems. We are glad we still have Baltimore represented on the committee.

We welcome you as well, Mr. Mfume.

Our credentials in academia are enhanced with the addition of David H. Price, a political science professor from Duke University in North Carolina. In between teaching the science of politics, David Price found time to actually practice politics as chairman of the Democratic Party in North Carolina and as staff director of the Hunt Commission that revised the Democratic delegation selection process in 1984.

We welcome you as well, Dr. Price.

Now I would like to turn to our ranking Republican, Chalmers Wylie, and ask him to introduce Members on his side.

Mr. WYLIE. Thank you very much, Mr. Chairman.

I have the pleasure of introducing four new Members: James Saxton, a Republican from Bensenton, NJ. He has the seat which was vacated by the late Representative Edward B. Forsyth, and he served in the State Legislature for 8 years. He went to East Carlsburg, PA, State College where he got his BA and has a Master's degree from Temple University. I don't see Jim here right now. Here he is. He made the second row. Good for you.

Pat Swindall is not here yet, I guess. I don't see him. But we will introduce him anyhow. He has a BA from the University of Georgia. He is a graduate from Georgia Law School, is a lawyer by occupation, and is from Dunwoody, GA. And we are glad to have Pat Swindall, who is in his second term in Congress.

Pat Saiki—did I get that right, Pat—who is from Hawaii, and we want to welcome her. She is the mother of five children, and she graduated from the University of Hawaii. She is a teacher by occupation, and this is her first term in Congress, and we are glad to have Pat Saiki on the committee.

We also have Jim Bunning, who is a little bit like McMillen—doesn't need much of an introduction—holds the seat once held by Gene Snyder, who retired. Jim, as you know, is a former professional baseball player, once pitched a no-hitter for the Detroit Tigers, and we are glad to have Jim Bunning. He also has some background in banking, so we know that he will make a significant contribution as a graduate of Xavier University with a Bachelor of Science degree.

Those are our four Members, Mr. Chairman. Thank you very much.

[The opening statement of Chairman Fernand J. St Germain follows:]

With a newly replenished fund, the regulators will be in a position to determine who lives and who dies among the sick of the savings and loan industry. The billions in new funds represent enormous new power for the regulators. How wisely and fairly this power is exercised will have tremendous impact on the industry and the ultimate cost to the Federal Government and the public in stabilizing these institutions.

Before introducing H. R. 27, I added a provision for oversight over the Federal Asset Disposition Association (FADA) which will be handling billions of dollars in assets of failed savings and loan institutions. The provision assures that the General Accounting Office will have ongoing specific authority to review and audit the activities of FADA and to provide the Congress with timely data on the agency.

Today's hearings are part of an effort by the Committee to get an early start in the 100th Congress. Next Tuesday, we will open hearings on H.R. 28, the Expedited Funds Availability Act---a major consumer initiative of this Committee. This same consumer legislation passed the House twice in the last Congress---once last January and again on October 7. Hopefully, it can and will be enacted this year.

Much of the impetus behind this particular plan--the idea of raising funds in the private market--comes from the Administration's fervent hope that it can avoid a major impact on the Federal budget as it deals with the industry's mounting problems.

Some in the industry are promoting alternatives to the Administration's plan---scaled down versions that would place regulators on a shorter string and require an earlier review of the process. We have an obligation to listen to these alternatives. However, it is important that the insurance fund and the industry be stabilized in a timely fashion. And we shall make certain that this is accomplished. There is limited time to experiment. Those who support alternatives have the burden of establishing the viability of their plans.

FSLIC recapitalization, under any of these plans, will give the Federal Home Loan Bank Board and FSLIC great flexibility in dealing with problem and failed savings and loans--something that the regulators insist they need to handle varied and complex problems of the industry.

If the plan does become law, the Congress should be sure it maintains tight and ongoing oversight to make certain that the word "flexible" doesn't become synonymous with arbitrary, capricious or wasteful.

We plan to move both of these bills--H.R. 27 and H.R. 28--to markup in the Financial Institutions Subcommittee on February 3 and markup in the full Committee on February 10.

The Housing Subcommittee will be conducting hearings on emergency assistance for the homeless on February 4 with a markup scheduled on February 5.

The measure for the homeless also will be brought up for markup in the full Committee on February 10 along with the FSLIC and expedited funds legislation.

Today we will hear from Gerald J. Levy, Immediate Past Chairman, U.S. League of Savings Institutions; David J. Sullivan, Jr., Treasurer, National Council of Savings Institutions and Patrick Forte, President, Association of Thrift Holding Companies.

The CHAIRMAN. Thank you, Mr. Wylie.

This morning the committee again takes up the administration's plan to recapitalize the Federal Savings and Loan Insurance Corporation. This is one of the measures that the committee went into at length in the 99th Congress.

The legislation was reported by the committee on September 23, 1986, and passed by the House on October 7, 1986. The bill died when the Senate failed to act in a timely manner.

H.R. 27 is a recognition of the serious drain on FSLIC as it attempts to deal with problems of the savings and loan industry that has suffered from periods of high interest rates and inflation, as well as mismanagement and excursions into risky ventures in search of the fast buck.

The administration's proposal would have the 12 Federal Home Loan Banks put up $3 billion as the capital for a new Financing Corporation that, in turn, would sell bonds in the market and raise an estimated $15 to $16 billion for FSLIC. This sum, combined with existing reserves and ongoing assessments and investments of FSLIC, could provide a $25- to $30 billion pot to shore up the insurance fund and to deal with the problems of the industry.

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We will wait for the introductions of the witnesses. Mr. Wylie?

[The following was submitted for inclusion in the record at this point: The text of H.R. 27.]

I

100TH CONGRESS
1ST SESSION

H. R. 27

To facilitate the provision of additional financial resources to the Federal Savings and Loan Insurance Corporation.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 6, 1987

Mr. ST GERMAIN (for himself and Mr. WYLIE) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

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A BILL

To facilitate the provision of additional financial resources to the Federal Savings and Loan Insurance Corporation.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Federal Savings and Loan Insurance Corporation Recapitalization Act of 1987".

SEC. 2. FINANCING CORPORATION ESTABLISHED.

The Federal Home Loan Bank Act (12 U.S.C. 1421 et seq.) is amended by inserting after section 20 the following new section:

"SEC. 21. FINANCING CORPORATION.

"(a) ESTABLISHMENT.—Notwithstanding any other provision of law, the Board shall charter a corporation to be known as the Financing Corporation.

"(b) MANAGEMENT OF FINANCING CORPORATION.—

"(1) DIRECTORATE.—The Financing Corporation shall be under the management of a directorate composed of 3 members as follows:

"(A) The Director of the Office of Finance of the Federal Home Loan Banks (or the head of any successor to such office).

"(B) 2 members selected by the Chairman of the Federal Home Loan Bank Board from among the presidents of the Federal Home Loan Banks.

"(2) TERMS.—Each member appointed under paragraph (1)(B) shall be appointed for a term of 1 year.

"(3) VACANCY.—If any member leaves the office in which such member was serving when appointed to the Directorate—

"(A) such member's service on the Directorate shall terminate on the date such member leaves such office; and

"(B) the successor to the office of such member shall serve the remainder of such member's term.

"(4) EQUAL REPRESENTATION OF BANKS.—No president of a Federal Home Loan Bank may be appointed to serve an additional term on the Directorate until such time as the presidents of each of the other Federal Home Loan Banks have served as many terms on the Directorate as the president of such bank (before the appointment of such president to such additional term).

"(5) CHAIRPERSON.—The Chairman of the Federal Home Loan Bank Board shall select the chairperson of the Directorate from among the 3 members of the Directorate.

"(6) STAFF.—

"(A) NO PAID EMPLOYEES.—The Financing Corporation shall have no paid employees.

"(B) POWERS.—The Directorate may, with the approval of the Board, authorize the officers, employees, or agents of the Federal Home Loan Banks to act for and on behalf of the Financing Corporation in such manner as may be necessary to carry out the functions of the Financing Corporation.

"(7) ADMINISTRATIVE EXPENSES.—

"(A) In general.—All administrative expenses of the Financing Corporation shall be paid by the Federal Home Loan Banks.

"(B) Pro rata distribution.—The amount each Federal Home Loan Bank shall pay shall be determined by the Board by multiplying the total administrative expenses for any period by the percentage arrived at by dividing—

"(i) the aggregate amount the Board required such bank to invest in the Financing Corporation (as of the time of such determination) under paragraphs (4) and (5) of subsection (d) (as computed without regard to paragraph (3) or (6) of such subsection); by

"(ii) the aggregate amount the Board required all Federal Home Loan Banks to invest (as of the time of such determination) under such paragraphs.

"(C) Administrative expenses defined.—For purposes of this paragraph, the term 'administrative expenses' does not include—

"(i) issuance costs (as such term is defined in subsection (g)(5)(A));

"(ii) any interest on (and any redemption premium with respect to) any obligation of the Financing Corporation; or

"(iii) custodian fees (as such term is defined in subsection (g)(5)(B)).

"(8) REGULATION BY BOARD.—The Directorate shall be subject to such regulations, orders, and directions as the Board may prescribe.

"(9) NO COMPENSATION FROM FINANCING CORPORATION.—Members of the Directorate shall receive no pay, allowances, or benefits from the Financing Corporation by reason of their service on the Directorate.

"(c) POWERS OF FINANCING CORPORATION.—The Financing Corporation shall have only the following powers, subject to the other provisions of this section and such regulations, orders, and directions as the Board may prescribe:

"(1) To issue nonvoting capital stock to the Federal Home Loan Banks.

"(2) To invest in any security issued by the Federal Savings and Loan Insurance Corporation under section 402(b) of the National Housing Act.

"(3) To issue debentures, bonds, or other obligations and to borrow, to give security for any amount borrowed, and to pay interest on (and any redemption

premium with respect to) any such obligation or amount.

"(4) To impose assessments in accordance with subsection (f).

"(5) To adopt, alter, and use a corporate seal.

"(6) To have succession until dissolved.

"(7) To enter into contracts.

"(8) To sue and be sued in its corporate capacity, and to complain and defend in any action brought by or against the Financing Corporation in any State or Federal court of competent jurisdiction.

"(9) To exercise such incidental powers not inconsistent with the provisions of this section or section 402(b) of the National Housing Act as are necessary or appropriate to carry out the provisions of this section.

"(d) CAPITALIZATION OF FINANCING CORPORATION.—

"(1) PURCHASE OF CAPITAL STOCK BY HOME LOAN BANKS.—

"(A) IN GENERAL.—Each Federal Home Loan Bank shall invest in nonvoting capital stock of the Financing Corporation at such times and in such amounts as the Board may prescribe under this subsection.

"(B) PAR VALUE; TRANSFERABILITY.—Each share of stock issued by the Financing Corporation to a Federal Home Loan Bank shall have par value in an amount determined by the Board and shall be transferable only among the Federal Home Loan Banks in the manner and to the extent prescribed by the Board at not less than par value.

"(2) AGGREGATE DOLLAR AMOUNT LIMITATION ON ALL INVESTMENTS.—The aggregate amount of funds invested by all Federal Home Loan Banks in nonvoting capital stock of the Financing Corporation shall not exceed $3,000,000,000.

"(3) MAXIMUM INVESTMENT AMOUNT LIMITATION FOR EACH HOME LOAN BANK.—The cumulative amount of funds invested in nonvoting capital stock of the Financing Corporation by each Federal Home Loan Bank shall not exceed the aggregate amount of—

"(A) the sum of—

"(i) the reserves maintained by such bank on December 31, 1985, pursuant to the requirement contained in the first 2 sentences of section 16; and

"(ii) the undivided profits (as defined in paragraph (7)) of such bank on such date; and

"(B) the sum of—

"(i) the amounts added to reserves after December 31, 1985, pursuant to the requirement contained in the first 2 sentences of section 16; and

"(ii) the undivided profits of such bank accruing after such date.

"(4) PRO RATA DISTRIBUTION OF 1ST $1,000,000,000 INVESTED IN FINANCING CORPORATION BY HOME LOAN BANKS.—With respect to the first $1,000,000,000 which the Board may require the Federal Home Loan Banks to invest in capital stock of the Financing Corporation under this subsection, the amount which each Home Loan Bank (or any successor to such bank) shall invest shall be determined by the Board by applying to the total amount of such investment by all such banks the percentage appearing in the following table for each such bank:

"Bank	Percentage
Federal Home Loan Bank of Boston	1.8629
Federal Home Loan Bank of New York	9.1006
Federal Home Loan Bank of Pittsburgh	4.2702
Federal Home Loan Bank of Atlanta	14.4007
Federal Home Loan Bank of Cincinnati	8.2653
Federal Home Loan Bank of Indianapolis	5.2863
Federal Home Loan Bank of Chicago	9.6886
Federal Home Loan Bank of Des Moines	6.9301

Federal Home Loan Bank of Dallas	8.8181
Federal Home Loan Bank of Topeka	5.2706
Federal Home Loan Bank of San Francisco	19.9644
Federal Home Loan Bank of Seattle	6.1422

"(5) PRO RATA DISTRIBUTION OF AMOUNTS REQUIRED TO BE INVESTED IN EXCESS OF $1,000,000,000.—With respect to any amount in excess of $1,000,000,000 which the Board may require the Federal Home Loan Banks to invest in capital stock of the Financing Corporation under this subsection, the amount which each Federal Home Loan Bank (or any successor to such bank) shall invest shall be determined by the Board by multiplying such excess amount by the percentage arrived at by dividing—

"(A) the sum of the total assets (as of the most recent December 31) held by all insured institutions which are members of such bank; by

"(B) the sum of the total assets (as of such date) held by all insured institutions which are members of any Federal Home Loan Bank.

"(6) SPECIAL PROVISIONS RELATING TO MAXIMUM AMOUNT LIMITATIONS.—

"(A) IN GENERAL.—If the amount any Federal Home Loan Bank is required to invest in capital stock of the Financing Corporation pursuant to a determination by the Board under paragraph (5) (or under subparagraph (B) of this para-

graph) exceeds the maximum investment amount applicable with respect to such bank under paragraph (3) at the time of such determination (hereinafter in this paragraph referred to as the 'excess amount')—

"(i) the Board shall require each remaining Federal Home Loan Bank to invest (in addition to the amount determined under paragraph (5) for such remaining bank and subject to the maximum investment amount applicable with respect to such remaining bank under paragraph (3) at the time of such determination) in such capital stock on behalf of the bank in the amount determined under subparagraph (B);

"(ii) the Board shall require the bank to subsequently purchase the excess amount of capital stock from the remaining banks in the manner described in subparagraph (C); and

"(iii) the requirements contained in subparagraphs (D) and (E) relating to the use of net earnings available for dividends shall apply to such bank until the bank has purchased all of the excess amount of capital stock.

"(B) ALLOCATION OF EXCESS AMOUNT AMONG REMAINING BANKS.—The amount each remaining Federal Home Loan Bank shall be required to invest under subparagraph (A)(i) is the amount determined by the Board by multiplying the excess amount by the percentage arrived at by dividing—

"(i) the amount of capital stock of the Financing Corporation held by such remaining bank at the time of such determination; by

"(ii) the aggregate amount of such stock held by all remaining banks at such time.

"(C) PURCHASE PROCEDURE.—The bank on whose behalf an investment in capital stock is made under subparagraph (A)(i) shall purchase, annually and at the issuance price, from each remaining bank an amount of such stock determined by the Board by multiplying the amount available for such purchases (at the time of such determination) by the percentage determined under subparagraph (B) with respect to such remaining bank until the aggregate amount of such capital stock has been purchased by the bank.

"(D) LIMITATION ON DIVIDENDS.—The amount of dividends which may be paid for any year by a bank on whose behalf an investment is made under subparagraph (A)(i) shall not exceed an amount equal to 1/2 of the net earnings available for dividends of the bank for the year.

"(E) TRANSFER TO ACCOUNT FOR PURCHASE OF STOCK REQUIRED.—Of the net earnings available for dividends for any year of a bank on whose behalf an investment is made under subparagraph (A)(i), such amount as is necessary to make the purchases of stock required under subparagraph (A)(ii) shall be placed in a reserve account (established in such manner as the Board shall prescribe by regulations) the balance in which shall be available only for such purchases.

"(F) NET EARNINGS AVAILABLE FOR DIVIDENDS DEFINED.—For purposes of this paragraph, the term 'net earnings available for dividends' means the net earnings of a bank for any period as computed after reducing the amount of earnings for such period by the amount required to be carried (for such period) to reserves maintained by such bank pursuant to the first two sentences of section 16 of this Act.

"(7) UNDIVIDED PROFITS DEFINED.—For purposes of paragraph (3), the term 'undivided profits' means retained earnings minus the sum of—

"(A) that portion required to be added to reserves maintained pursuant to the first two sentences of section 16 of this Act; and

"(B) the dollar amounts held by the respective Federal Home Loan Banks in special dividend stabilization reserves on December 31, 1985, as determined under the following table:

"Bank	Dollar amount
Federal Home Loan Bank of Boston	$3.2 million
Federal Home Loan Bank of New York	7.7 million
Federal Home Loan Bank of Pittsburgh	5.2 million
Federal Home Loan Bank of Atlanta	12.3 million
Federal Home Loan Bank of Cincinnati	5.9 million
Federal Home Loan Bank of Indianapolis	37.4 million
Federal Home Loan Bank of Chicago	6.0 million
Federal Home Loan Bank of Des Moines	32.7 million
Federal Home Loan Bank of Dallas	45.0 million
Federal Home Loan Bank of Topeka	13.7 million
Federal Home Loan Bank of San Francisco	21.9 million
Federal Home Loan Bank of Seattle	33.6 million

"(e) OBLIGATIONS OF THE FINANCING CORPORATION.—

"(1) LIMITATION ON AMOUNT OF OUTSTANDING OBLIGATIONS.—The aggregate amount of obligations of the Financing Corporation which may be outstanding at any time (as determined by the Board) shall not exceed the greater of—

"(A) 5 times the amount of the nonvoting capital stock of the Financing Corporation which is outstanding at such time; or

"(B) the sum of the face amounts (the amount of principal payable at maturity) of securities described in subsection (g)(2) which are held at such time in the segregated account established pursuant to such subsection.

"(2) NET PROCEEDS TO BE INVESTED IN CAPITAL OF FSLIC.—Subject to such terms and conditions as may be approved by the Board, the net proceeds of any obligation issued by the Financing Corporation shall be used to—

"(A) purchase capital certificates or capital stock issued by the Federal Savings and Loan Insurance Corporation under section 402(b)(1)(A) of the National Housing Act; or

"(B) refund any previously issued obligation the net proceeds of which were invested in the manner described in subparagraph (A).

"(3) LIMITATION ON TERM OF OBLIGATIONS.—No obligation of the Financing Corporation may be issued which matures—

"(A) more than 30 years after the date of issue; or

"(B) after December 31, 2026.

"(4) INVESTMENT OF UNITED STATES FUNDS IN OBLIGATIONS.—Obligations issued under this section by the Financing Corporation with the approval of the Board shall be lawful investments, and may be accepted as security, for all fiduciary, trust, and public funds the investment or deposit of which shall be under the authority or control of the United States or any officer of the United States.

"(5) MARKET FOR OBLIGATIONS.—All persons having the power to invest in, sell, underwrite, purchase for their own accounts, accept as security, or otherwise deal in obligations of the Federal Home Loan Banks shall also have the power to do so with respect to obligations of the Financing Corporation.

"(6) NO FULL FAITH AND CREDIT OF THE UNITED STATES.—Obligations of the Financing Corporation and the interest payable on such obligations shall not be obligations of, or guaranteed as to principal or interest by, the Federal Home Loan Banks, the United States, or the Federal Savings and Loan Insurance Corporation and the obligations shall so plainly state.

"(7) TAX EXEMPT STATUS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), obligations of the Financing Corporation shall be exempt from tax both as to principal and interest to the same extent as any obligation of a Federal Home Loan Bank is exempt from tax under section 13.

"(B) EXCEPTION.—The Financing Corporation, like the Federal Home Loan Banks, shall be treated as an agency of the United States for purposes of the first sentence of section 3124(b) of title 31, United States Code (relating to determination of tax status of interest on obligations).

"(8) OBLIGATIONS ARE EXEMPT SECURITIES.—Notwithstanding paragraph (6), obligations of the Financing Corporation shall be deemed to be exempt securities (within the meaning of laws administered by the Securities and Exchange Commission) to the same extent as securities which are direct obligations of the United States or are guaranteed as to principal or interest by the United States.

"(f) ASSESSMENT AUTHORITY OF THE FINANCING CORPORATION.—

"(1) IN GENERAL.—The Financing Corporation may, with the approval of the Board, assess semiannually on each insured institution an assessment, except

that the aggregate amount assessed under this paragraph on any insured institution for any year may not exceed an amount equal to 1/12th of 1 percent of the aggregate amount of all accounts of insured members of such insured institution for such year.

"(2) SUPPLEMENTAL ASSESSMENT AUTHORIZED.—Upon the unanimous vote of the Directorate that additional funds are needed to pay the interest on the obligations of the Financing Corporation because no other funds are available, the Financing Corporation may, with the approval of the Board and in addition to any assessment assessed under paragraph (1), assess on each insured institution an assessment, except that the aggregate amount assessed under this paragraph on any insured institution for any year may not exceed an amount equal to 1/8th of 1 percent of the aggregate amount of all accounts of insured members of such insured institution for such year.

"(3) TOTAL AMOUNT OF ASSESSMENTS MAY NOT EXCEED INTEREST AND FINANCING COSTS.—The aggregate amount of all assessments assessed under paragraphs (1) and (2) for any year may not exceed—

"(A) the aggregate amount of—

"(i) issuance costs (as such term is defined in subsection (g)(5)(A)) incurred

respect to obligations issued during such year;

"(ii) interest paid on (and any redemption premium paid with respect to) obligations of the Financing Corporation during such year; and

"(iii) custodian fees (as such term is defined in subsection (g)(5)(B)) incurred during such year; minus

"(B) the aggregate amount of any payments under subsection (g)(4) during such year.

"(4) PAYMENT TO FINANCING CORPORATION.—All assessments assessed by the Financing Corporation under paragraph (1) or (2) shall be paid to the Financing Corporation.

"(g) USE AND DISPOSITION OF ASSETS OF THE FINANCING CORPORATION NOT INVESTED IN FSLIC.—

"(1) IN GENERAL.—Subject to such regulations, restrictions, and limitations as may be prescribed by the Board, assets of the Financing Corporation which are not invested in capital certificates or capital stock issued by the Federal Savings and Loan Insurance Corporation under section 402(b)(1)(A) of the National Housing Act shall be invested in—

"(A) direct obligations of the United States,

"(B) obligations, participations, or other instruments of, or issued by, the Federal National Mortgage Association or the Government National Mortgage Association;

"(C) mortgages, obligations, or other securities for sale by, or which have been disposed of by, the Federal Home Loan Mortgage Corporation under section 305 or 306 of the Federal Home Loan Mortgage Corporation Act; or

"(D) any other security in which it is lawful for fiduciary and trust funds to be invested under the laws of any State.

"(2) SEGREGATED ACCOUNT FOR ZERO COUPON INSTRUMENTS HELD TO ASSURE PAYMENT OF PRINCIPAL.—The Financing Corporation shall invest in, and hold in a segregated account, noninterest bearing instruments—

"(A) which are securities described in paragraph (1); and

"(B) the total of the face amounts (the amount of principal payable at maturity) of which is approximately equal to the aggregate amount of principal on the obligations of the Financing Corporation,

to assure the repayment of principal on obligations of the Financing Corporation.

"(3) DOLLAR AMOUNT LIMITATION ON INVESTMENT IN ZERO COUPON INSTRUMENTS FOR SEGREGATED ACCOUNT.—The aggregate amount invested by the Financing Corporation under paragraph (2) shall not exceed $2,200,000,000 (as determined on the basis of the purchase price).

"(4) EXCEPTION FOR PAYMENT OF ISSUANCE COSTS, INTEREST, AND CUSTODIAN FEES.—Notwithstanding the requirements of paragraph (1), the assets of the Financing Corporation referred to in paragraph (1) which are not invested under paragraph (2) may be used to pay—

"(A) issuance costs;

"(B) any interest on (and any redemption premium with respect to) any obligation of the Financing Corporation; and

"(C) custodian fees.

"(5) DEFINITIONS.—For purposes of this subsection—

"(A) ISSUANCE COSTS.—The term 'issuance costs'—

"(i) means issuance fees and commissions incurred by the Financing Corporation

in connection with the issuance or servicing of any obligation of the Financing Corporation; and

"(ii) includes legal and accounting expenses, trustee and fiscal and paying agent charges, costs incurred in connection with preparing and printing offering materials, and advertising expenses, to the extent that any such cost or expense is incurred by the Financing Corporation in connection with issuing any obligation.

"(B) CUSTODIAN FEES.—The term 'custodian fee' means—

"(i) any fee incurred by the Financing Corporation in connection with the transfer of any security to, or the maintenance of any security in, the segregated account established under paragraph (2); and

"(ii) any other expense incurred by the Financing Corporation in connection with the establishment or maintenance of such account.

"(h) MISCELLANEOUS PROVISIONS RELATING TO FINANCING CORPORATION.—

"(1) TREATMENT FOR CERTAIN PURPOSES.—Except as provided in subsection (e)(7)(B), the Financing Corporation shall be treated as a Federal Home Loan Bank for purposes of sections 13 and 23.

"(2) SUNSET PROVISION FOR BORROWING AUTHORITY.—No net new borrowing may be made by the Financing Corporation after December 31, 1996.

"(3) FEDERAL RESERVE BANKS AS DEPOSITARIES AND FISCAL AGENTS.—The Federal Reserve banks are authorized to act as depositaries for or fiscal agents or custodians of the Financing Corporation.

"(4) APPLICABILITY OF CERTAIN PROVISIONS RELATING TO GOVERNMENT CORPORATION.—Notwithstanding the fact that no government funds may be invested in the Financing Corporation, the Financing Corporation shall be treated, for purposes of sections 9105, 9107, and 9108 of title 31, United States Code, as a mixed-ownership Government corporation which has capital of the Government.

"(5) QUARTERLY REPORTS TO CONGRESS.—

"(A) REPORT REQUIRED.—Before the end of the 2-week period beginning on the first day of each calendar quarter, the Financing Corporation shall submit a detailed written report on the preceding calendar quarter to the Committee on

Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate.

"(B) CONTENTS OF REPORT.—Each report required under paragraph (1) shall contain a complete description of—

"(i) all activities of the Financing Corporation during the calendar quarter with respect to which the report is made;

"(ii) the financial condition of the Financing Corporation as of the end of such calendar quarter;

"(iii) all income of the Financing Corporation during such calendar quarter and the source of such income; and

"(iv) all expenditures made or expenses paid by the Financing Corporation during such calendar quarter, including administrative expenses and any expense which—

"(I) was incurred in connection with an activity of the Financing Corporation; and

"(II) was paid by any other person on behalf of or for the benefit of the Financing Corporation.

"(i) Federal Savings and Loan Insurance Corporation Industry Advisory Committee.—

"(1) Establishment.—There is hereby established the Federal Savings and Loan Insurance Corporation Industry Advisory Committee (hereinafter in this subsection referred to as the 'Committee').

"(2) Membership.—

"(A) Appointment.—The Committee shall consist of 13 members selected as follows:

"(i) 1 member appointed by the Chairman of the Board from among individuals who are officers of insured institutions and who are not members of the Board or employees of the Board, the Federal Savings and Loan Insurance Corporation, or the Board of Directors of any Federal Home Loan Bank.

"(ii) 1 member elected from each Federal Home Loan Bank district (by the members of the Board of Directors of each such bank who were elected by the members of such bank) from among individuals who are officers of insured institutions.

"(B) Terms.—Members shall be appointed or elected for terms of 1 year.

"(C) Chairperson.—The member appointed under subparagraph (A)(i) shall be the chairperson of the Committee.

"(D) Vacancies.—Any vacancy on the Committee shall be filled in the manner in which the original appointment was made.

"(E) Pay and expenses.—Members of the Committee shall serve without pay but each member of the Committee shall be reimbursed, in such manner as the Board may prescribe by regulation, by the Federal Home Loan Bank which elected such member (and, in the case of the member appointed by the Chairman of the Board, by the Board) for expenses incurred in connection with attendance of such members at meetings of the Committee.

"(F) Meetings.—The Committee shall meet from time to time at the call of the chairperson or a majority of the members.

"(3) Duties of the committee.—The duties of the Committee are as follows:

"(A) To review the reports and budgets prepared pursuant to section 402(k) of the National Housing Act and any other matter which the

Board may present for the Committee's consideration.

"(B) To confer with the Board on the reports, budgets, and other matters reviewed under subparagraph (A).

"(C) To prepare written comments and recommendations for the Board and the Federal Savings and Loan Insurance Corporation with respect the reports, budgets, and other matters reviewed under subparagraph (A) (which shall be submitted to the Board in a timely manner after each meeting).

"(4) ANNUAL REPORT.—

"(A) REQUIRED.—Not later than January 15 of each year, the Committee shall submit a report to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate.

"(B) CONTENTS.—The report required under subparagraph (A) shall describe the activities of the Committee during the preceding year and the reports and recommendations made by the Committee to the Board and the Federal Savings and Loan Insurance Corporation during such year.

"(5) REGULATIONS.—The Board shall prescribe such regulations as the Board determines to be appropriate to avoid conflicts of interest with respect to the disclosure to and use by members of the Committee of information relating to the Board, the Federal Savings and Loan Insurance Corporation, the Federal Home Loan Banks, and the Federal Asset Disposition Association.

"(6) FEDERAL ADVISORY COMMITTEE ACT DOES NOT APPLY.—The Federal Advisory Committee Act shall not apply to the Committee.

"(7) TERMINATION.—The Committee shall terminate when the Financing Corporation terminates under subsection (j).

"(j) TERMINATION OF THE FINANCING CORPORATION.—

"(1) IN GENERAL.—The Financing Corporation shall be dissolved, as soon as practicable, after the earlier of—

"(A) the date by which all stock purchased by the Financing Corporation in the Federal Savings and Loan Insurance Corporation has been retired; or

"(B) December 31, 2026.

"(2) BOARD AUTHORITY TO CONCLUDE THE AFFAIRS OF FINANCING CORPORATION.—Effective on the date of the dissolution of the Financing Corporation under paragraph (1), the Board may exercise, on behalf of the Financing Corporation, any power of the Financing Corporation which the Board determines to be necessary to settle and conclude the affairs of the Financing Corporation.

"(k) REGULATIONS.—The Board may prescribe such regulations as may be necessary to carry out the provisions of this section, including regulations defining terms used in this section.

"(l) DEFINITIONS.—For purposes of this section—

"(1) INSURED INSTITUTION.—The term 'insured institution' has the meaning given to such term by section 401(a) of the National Housing Act.

"(2) INSURED MEMBER.—The term 'insured member' has the meaning given to such term by section 401(b) of the National Housing Act.

"(3) DIRECTORATE.—The term 'Directorate' means the directorate established in the manner provided in subsection (b)(1) to manage the Financing Corporation.".

SEC. 3. MIXED OWNERSHIP GOVERNMENT CORPORATION.

Section 9101(2) of title 31, United States Code, is amended by adding at the end thereof the following new subparagraph:

"(K) The Financing Corporation.".

SEC. 4. RECAPITALIZATION OF FSLIC.

Section 402(b) of the National Housing Act (12 U.S.C. 1725(b)) is amended to read as follows:

"(b) ISSUANCE AND SALE OF CAPITAL CERTIFICATES AND STOCK TO FINANCING CORPORATION.—

"(1) AUTHORIZATION TO ISSUE.—

"(A) IN GENERAL.—Notwithstanding any other provision of law, the Corporation may issue—

"(i) nonredeemable capital certificates; and

"(ii) redeemable nonvoting capital stock.

"(B) REQUIREMENT RELATING TO AMOUNT OF STOCK.—The aggregate amount of stock issued by the Corporation under subparagraph (A)(ii) shall be equal to the aggregate amount of the investments made by the Federal Home Loan Banks in the capital stock of the Financing Corporation under section 21 of the Federal Home Loan Bank Act.

"(C) CERTIFICATES AND STOCK MAY BE SOLD ONLY TO FINANCING CORPORATION.—Capital certificates and stock issued under subparagraph (A) may be sold only to the Financing Corporation in the manner and to the extent provided in section 21 of the Federal Home Loan Bank Act and this subsection.

"(D) PROCEEDS OF SALE ARE PART OF PRIMARY RESERVE.—The proceeds of any sale of capital certificates or stock under this subparagraph shall be considered part of the primary reserve established by the Corporation pursuant to section 404(a).

"(E) NO DIVIDENDS.—The Corporation shall pay no dividends on any capital certificates or stock issued under this subparagraph.

"(2) EQUITY RETURN ACCOUNT.—

"(A) IN GENERAL.—The Corporation shall establish and maintain (until all capital certificates and stock issued under subparagraph (A) have been paid off and retired) an equity return account—

"(i) which shall consist only of amounts contributed in accordance with the requirements of subparagraph (B);

"(ii) which shall not be treated as reserves of the Corporation; and

"(iii) the earnings accruing in which shall be transferred in the manner provided in subparagraph (D).

"(B) CONTRIBUTIONS TO ACCOUNT.—

"(i) NO CONTRIBUTION IF RESERVES-TO-ACCOUNTS RATIO IS LESS THAN 0.5 PERCENT.—No contribution shall be made to the equity reserve account established pursuant to subparagraph (A) in any year in which the reserves-to-accounts ratio is less than 0.5 percent.

"(ii) ANNUAL CONTRIBUTIONS REQUIRED.—Except as provided in clause (i), the Corporation shall make contributions to the equity reserve account established pursuant to subparagraph (A)—

"(I) at the end of each year beginning after 1996 through the final payoff year (as defined in clause (vii); and

"(II) in amounts determined under clauses (iii), (iv), (v), and (vi) of this subparagraph.

"(iii) AMOUNT OF PRIMARY CONTRIBUTION.—The primary contribution to the equity return account for any year for which a contribution is required to be made shall be the amount determined by dividing—

"(I) the aggregate amount of capital stock issued by the Corporation and purchased by the Financing Corporation under paragraph (1)(A); by

"(II) the number of years between the first year beginning after 1996 in which the reserves-to-accounts ratio is equal to or greater than 0.5 percent and the final payoff year (taking into account the first and last year described).

"(iv) AMOUNT OF ADDITIONAL CONTRIBUTION ALLOWED IF RESERVES-TO-ACCOUNTS RATIO DOES NOT EXCEED 1.25 PERCENT.—In any year in which the reserves-to-accounts ratio is equal to or greater than 1 percent but less than 1.25 percent, the Federal Home Loan Bank Board may require the Corporation to make an additional contribution of an amount not to exceed the amount determined by dividing—

"(I) the investment return amount (as defined in clause (viii)) computed at an annual compound rate not to exceed 6 percent; by

"(II) the number of years between the first year beginning after 1996 in which the reserves-to-accounts ratio was equal to or greater than 1 percent and the final payoff year (taking into account the first and last year described).

"(v) AMOUNT OF ADDITIONAL CONTRIBUTION ALLOWED IF RESERVES-TO-ACCOUNTS RATIO DOES NOT EXCEED 1.75 PERCENT.—In any year in which the reserves-to-accounts ratio is equal to or greater than 1.25 percent but less than 1.75 percent, the Federal Home Loan Bank Board may require the Corporation to make an additional contribution of an amount not to exceed the amount determined by dividing—

"(I) the investment return amount computed at an annual compound rate not to exceed 8 percent, minus the sum

of any amounts contributed under clause (iv); by

"(II) the number of years between the first year beginning after 1996 in which the reserves-to-accounts ratio was equal to or greater than 1.25 percent and the final payoff year (taking into account the first and last year described).

"(vi) AMOUNT OF ADDITIONAL CONTRIBUTION ALLOWED IF RESERVES-TO-ACCOUNTS RATIO EXCEEDS 1.75 PERCENT.—In any year in which the reserves-to-accounts ratio is equal to or greater than 1.75 percent, the Federal Home Loan Bank Board may require the Corporation to make an additional contribution of an amount not to exceed the amount determined by dividing—

"(I) the investment return amount computed at an annual compound rate not to exceed 10 percent, minus the sum of any amounts contributed under clause (iv) or (v); by

"(II) the number of years between the first year beginning after 1996 in which the reserves-to-accounts ratio was equal to or greater than 1.75 percent and the final payoff year (taking into account the first and last year described).

"(vii) FINAL PAYOFF YEAR DEFINED.—For purposes of this subparagraph, the term 'final payoff year' means the year of maturity of the last maturing obligation of the Financing Corporation (which was issued under section 21 of the Federal Home Loan Bank Act and matures before January 1, 2027).

"(viii) INVESTMENT RETURN AMOUNT.—For purposes of clauses (iv), (v), and (vi), the term 'investment return amount' means the amount which would be realized on the aggregate amount invested by the Financing Corporation in capital stock issued by the Corporation under paragraph (1) over the period of the investment if the return on the investment is computed at the rate described in subclause (I) of the respective clauses.

"(C) INVESTMENT OF AMOUNTS IN ACCOUNT.—Amounts accumulating in the equity return account may be invested in such manner as the Corporation determines.

"(D) TRANSFER OF EARNINGS TO PRIMARY RESERVE.—Earnings accruing on any investment (under subparagraph (C)) of amounts in the equity return account shall be transferred to the primary reserve account of the Corporation established pursuant to section 404(a) as such earnings are realized by the Corporation and shall not be treated as amounts in the account.

"(E) RETIREMENT OF CAPITAL STOCK USING BALANCE IN ACCOUNT.—Upon maturity of all obligations of the Financing Corporation under section 21 of the Federal Home Loan Bank Act, the Corporation shall payoff and retire any capital stock issued under paragraph (1)(A)(ii) using only amounts accumulated in the equity return account.

"(F) RESERVES-TO-ACCOUNTS RATIO DEFINED.—For purposes of this paragraph, the term 'reserves-to-accounts ratio' means, with respect to any year, the amount determined by dividing—

"(i) the amount of reserves of the Corporation (determined as of December 31 of the preceding year); by

"(ii) the aggregate amount of all accounts of all of its insured members (determined as of such date).

"(3) FINANCING CORPORATION DEFINED.—For purposes of this subsection, the term 'Financing Corporation' means the Financing Corporation established under section 21 of the Federal Home Loan Bank Act.

"(4) NO REDUCTION OR SUSPENSION OF INSURANCE PREMIUMS WHILE STOCK IS OUTSTANDING.—Notwithstanding any other provision of law, the provisions of subsections (b)(2), (d)(1)(B), and (g) of section 404 shall not apply as long as any share of capital stock issued under paragraph (1)(A)(ii) is outstanding.".

SEC. 5. FSLIC AUTHORITY TO CHARGE PREMIUMS REDUCED BY AMOUNT OF FINANCING CORPORATION ASSESSMENTS.

Section 404 of the National Housing Act is amended by redesignating subsections (d) through (i) as subsections (e) through (j), respectively, and by inserting after subsection (c) the following new subsection:

"(d) AUTHORITY TO CHARGE PREMIUMS REDUCED BY AMOUNT OF FINANCING CORPORATION ASSESSMENTS.—

Notwithstanding any other provision of this section, the sum of—

"(1) the amount of any premium required to be paid by any insured institution under subsection (b)(1); and

"(2) the amount of any premium authorized to be assessed by the Corporation under subsection (c) with respect to such institution,

for any period shall be reduced by the amount of any assessment paid for such period by such insured institution to the Financing Corporation pursuant to section 21(f) of the Federal Home Loan Bank Act.".

SEC. 6. MISCELLANEOUS PROVISIONS.

(a) FEDERAL HOME LOAN BANK DIVIDENDS.—Section 16 of the Federal Home Loan Bank Act (12 U.S.C. 1436) is amended by adding at the end thereof the following new subsection:

"(c) EXCEPTION IN CASE OF LOSSES IN CONNECTION WITH FINANCING CORPORATION STOCK.—

"(1) IN GENERAL.—Notwithstanding subsection (a) of this section, if—

"(A) a Federal Home Loan Bank incurs a chargeoff or an expense in connection with such bank's investment in the stock of the Financing Corporation under section 21;

"(B) the Board determines there is an extraordinary need for the member institutions of the bank to receive dividends; and

"(C) the bank has reduced all reserves (other than the reserve account required by the first 2 sentences of subsection (a)) to zero,

the Board may authorize such bank to declare and pay dividends out of undivided profits (as such term is defined in section 21(d)(7)) or the reserve account required by the first 2 sentences of subsection (a).

"(2) REQUIREMENTS OF SECTION 21 NOT AFFECTED.—Notwithstanding any payment of dividends by any Federal Home Loan Bank pursuant to an authorization by the Board under paragraph (1), the applicable provisions of section 21 shall continue to apply with respect to such bank, and to such bank's investment in the Financing Corporation, in the same manner and to the same extent as if such payment had not been made.".

(b) CONFORMING AMENDMENT.—Section 402(h) of the National Housing Act (12 U.S.C. 1725(h)) is amended—

(1) by striking out "After the effective date" and inserting in lieu thereof "(1) After the effective date"; and

(2) by adding at the end thereof the following new paragraph:

"(2) The first three sentences of paragraph (1) shall not apply to stock issued by the Corporation to the Financing Corporation under subsection (b)(1)(A).".

(c) LIMITATION ON SPECIAL ASSESSMENT.—Section 404(c) of the National Housing Act (12 U.S.C. 1727(c)) is amended—

(1) by striking out "(c) The Corporation" and inserting in lieu thereof "(c)(1) SPECIAL ASSESSMENT.—Subject to paragraph (2), the Corporation"; and

(2) by adding at the end thereof the following new paragraph:

"(2) LIMITATIONS ON AMOUNT OF ASSESSMENT.—The amount of any additional premium assessed by the Corporation against any insured institution under paragraph (1) in any of the following years shall not exceed the amount listed in connection with each such year in the following table (unless the Federal Home Loan Board determines that severe pressures on the Corporation exist which necessitate an infusion of additional funds):

"For year:	**The amount of the additional premium may not exceed:**
1987	$\frac{5}{48}$ of 1 percent of the total amount of the accounts of the insured members of such institution

"For year:	The amount of the additional premium may not exceed:
1988	$\frac{1}{12}$ of 1 percent of the total amount of the accounts of the insured members of such institution
1989	$\frac{1}{16}$ of 1 percent of the total amount of the accounts of the insured members of such institution
1990	$\frac{1}{24}$ of 1 percent of the total amount of the accounts of the insured members of such institution
1991	$\frac{1}{48}$ of 1 percent of the total amount of the accounts of the insured members of such institution.

(d) PRIORITY OF SECURED INTERESTS.—Section 10 of the Federal Home Loan Bank Act (12 U.S.C. 1430) is amended by adding at the end thereof the following new subsection:

"(e) PRIORITY OF CERTAIN SECURED INTERESTS.—Notwithstanding any other provision of law, any security interest granted to a Federal Home Loan Bank by any member of any Federal Home Loan Bank or any affiliate of any such member shall be entitled to priority over the claims and rights of any party (including any receiver, conservator, trustee, or similar party having rights of a lien creditor) other than the claims of secured parties that are secured by actual perfected security interests that would be entitled to priority under otherwise applicable law.".

(e) FSLIC REPORT REQUIREMENTS.—Section 402 of the National Housing Act is amended by adding at the end thereof the following new subsection:

"(k) REPORTS AND BUDGETS REQUIRED.—

"(1) QUARTERLY REPORTS AND BUDGETS.—Before the end of the 2-week period beginning on the first day of each calendar quarter, the Corporation shall complete a detailed written report and budget describing and explaining—

"(A) planned or anticipated activities and estimates of receipts and expenditures for such calendar quarter; and

"(B) the activities, receipts, and expenditures for the preceding calendar quarter.

"(2) SEMIANNUAL REPORT.—Before the end of the 30-day period beginning on the first day of each semiannual period, the Corporation shall complete a detailed written report and budget describing and explaining the activities, receipts, and expenditures for the preceding semiannual period.

"(3) SUBMISSION OF SEMIANNUAL REPORT TO CONGRESS.—The Corporation shall submit a copy of each semiannual report required under paragraph (2) to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate.

"(4) ACTIVITIES, ETC., OF FEDERAL ASSET DISPOSITION ASSOCIATION.—Activities, receipts, and expenditures of the Federal Asset Disposition Association

(or any successor thereto) shall be included in any report or budget required under this subsection.

"(5) DEFINITIONS.—For purposes of this subsection—

"(A) ACTIVITIES.—The term 'activities' includes any activity engaged in with respect to any insured institution in financial difficulty.

"(B) SEMIANNUAL PERIOD.—The term 'semiannual period' means—

"(i) the period beginning on January 1 of any calendar year and ending June 30 of such year; and

"(ii) the period beginning on July 1 of any calendar year and ending December 31 of such year.".

(f) SECONDARY RESERVE.—Section 404 of the National Housing Act (12 U.S.C. 1727) is amended by striking out subsection (i) (as redesignated by section 5).

SEC. 7. FEDERAL ASSET DISPOSITION ASSOCIATION.

(a) STATUS AS MIXED-OWNERSHIP GOVERNMENT CORPORATION.—

(1) IN GENERAL.—Section 9101(2) of title 31, United States Code (as amended by section 3) is amended by adding at the end thereof the following new subparagraph:

"(L) the Federal Asset Disposition Association (as defined in section 7(d) of the Federal Savings and Loan Insurance Corporation Recapitalization Act of 1987).".

(2) APPLICABILITY OF CERTAIN PROVISIONS RELATING TO GOVERNMENT CORPORATIONS.—Whether or not government funds are invested in the Federal Asset Disposition Association, such Association shall be treated, for purposes of sections 9105, 9107, and 9108 of title 31, United States Code, as a mixed-ownership Government corporation which has capital of the United States.

(3) ANNUAL AUDIT REQUIRED.—Section 9105(a)(2) of title 31, United States Code, is amended by inserting ", the Federal Asset Disposition Association (as defined in section 7(d) of the Federal Savings and Loan Insurance Corporation Recapitalization Act of 1987)," after "Insurance Corporation".

(b) QUARTERLY REPORTS TO CONGRESS.—

(1) REPORT REQUIRED.—Before the end of the 2-week period beginning on the first day of each calendar quarter, the Federal Asset Disposition Association shall complete a detailed written report on the preceding calendar quarter to the Committee on Banking, Finance and Urban Affairs of the House of Representa-

tives and the Committee on Banking, Housing, and Urban Affairs of the Senate.

(2) CONTENTS OF REPORT.—Each report required under paragraph (1) shall contain a complete description of—

(A) all activities of the Federal Asset Disposition Association during the calendar quarter for which the report is made;

(B) the financial condition of the Association as of the end of such calendar quarter;

(C) all income of the Association during such calendar quarter and the source of such income;

(D) all expenditures made or expenses paid by the Association during such calendar quarter, including administrative expenses and any expense which—

(i) was incurred in connection with an activity of the Association; and

(ii) was paid by any other person on behalf of or for the benefit of the Association; and

(E) the amount of capital of the Federal Savings and Loan Insurance Corporation which was returned to such Corporation during such calendar quarter.

(c) OPEN MEETING REQUIREMENT.—The Federal Asset Disposition Association shall be treated as an agency for purposes of section 552b of title 5, United States Code.

(d) FEDERAL ASSET DISPOSITION ASSOCIATION DEFINED.—For purposes of this section, the term "Federal Asset Disposition Association" means the savings and loan association established by the Federal Savings and Loan Insurance Corporation under section 406 of the National Housing Act to manage and liquidate nonperforming assets on behalf of such Corporation in accordance with such section.

Mr. WYLIE. Thank you, Mr. Chairman.

I wish to compliment you for the early start on hearings on this very important subject. It is unprecedented for us to have hearings before the committee organizes, but I think it is warranted in view of the urgency of the problem we now face, and I, too, would like to welcome our panel of industry representatives this morning. It is a very distinguished panel indeed, and it is critical that we hear from them, since if any FSLIC recapitalization plan is going to work, it must have the support of the industry itself.

Mr. Chairman, we are all aware of the situation confronting FSLIC. The Federal Home Loan Bank Board tells us that FSLIC's primary reserve has fallen to less than $2 billion and because of insufficient funds, FSLIC has been forced to postpone resolution of problem cases. The costs of warehousing problem thrifts has grown to $6 million per day, a staggering amount that almost equals FSLIC's entire income on an annualized basis.

As the GAO reported last fall, further delaying resolution of problem cases will add substantially to the ultimate costs of industry and to the economy.

While there have been disagreements over specifics, I think that all recognize the critical need to provide FSLIC with additional resources; recapitalization will preserve public confidence in our Nation's thrift institutions, and should help diminish the interest rate premiums that a number of S&Ls currently have to pay to attract and maintain deposits.

In short, while some have doubt about the ultimate effectiveness of this particular proposal, whether it provides enough funds, I believe it represents a positive step forward and it should put us well on the way to eliminating the drag the small minority of troubled thrifts have had on the healthy majority, and I look forward to the testimony this morning, and I can assure you, Mr. Chairman, that you will once again have my full support in expeditiously moving the recapitalization bill.

The CHAIRMAN. Thank you.

I will take this opportunity now to go back to the introductory phase, and welcome our last new member. We increase our representation from New York and the clergy in Floyd Flake from the 6th District in Queens. Floyd Flake is a minister who truly has been an activist in promoting housing, senior citizen facilities and small business efforts in Queens, a background and expertise that we need on this committee.

We welcome you as well, Mr. Flake, to our panel.

Mr. WYLIE. Mr. Chairman, Mr. Pat Swindall from Georgia has now arrived. I already gave you his credentials, but welcome to the committee, Pat.

The CHAIRMAN. I recognize Mr. Gonzalez for a unanimous consent request.

Mr. GONZALEZ. Thank you very much, Mr. Chairman.

I ask unanimous consent that at this point in the record, when we enter into the testimonial portion, that we incorporate into the record testimony sent by Mr. Mario G. Obledo, who is a former national president of the League of United Latin American Citizens now in Sacramento, CA. Finding himself unable to be present to

render the testimony personally, he asked that I submit it for the record, and ask unanimous consent that we do so.

The CHAIRMAN. If there be no objection, the testimony will be placed in the record at the conclusion of the testimony of the witnesses, the panel that is before us.

Is there objection? The Chair hears none.

The Chair might state it is unfortunate that the time element was off, but we certainly would like to have had him in person, but we do appreciate his making an effort and going to the trouble of preparing his testimony for us.

The Chair recognizes Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Chairman, I first want to concur in your opening statement this morning as well as to commend you for having these very early hearings on this very, very important issue, the FSLIC recapitalization bill.

However, I fear that we, from the advanced information, that we may find ourselves involved in other controversial issues, which I hope will not happen as far as this particular bill is concerned, and I hope that we will stay clear of some of the collateral issues which have been indicated that might be in this particular consideration.

I fear that there is some trend developing to involve us in one of the most controversial issues now facing the savings and loan industry, and this is a matter of direct investments.

I must confess I was somewhat surprised to see a major piece on this subject included in the packet of materials for this hearing which I received, and that piece properly notes that in 1985 I supported a compromise amendment that related to direct investments.

Well, Mr. Chairman, a lot of water has flowed under the dam since then. My subcommittee and House Government Operations has continued to study whether direct investments are good or bad for the savings and loan industry since then. It has been one of the most hotly contested issues. Basically, are they in and of themselves dangerous? Correctly, I believe the Federal Home Loan Bank itself has decided to hold hearings on this question.

It is my hope that the Bank Board will be able to resolve what this committee should not delay in solving, and this is the proper methodology for determining whether direct investments are good or bad.

This has been the problem all along, that no one has come up with the figures which makes the case one way or the other.

At the time my Government Operations Subcommittee endorsed the rule, we did so with many qualifications, and obviously said the matter needed further study, and that study is about ready to take place.

Let us not get tied up in the many difficult byways of this issue when we have to get on with this very important subject of recapitalization. Thank you very much.

The CHAIRMAN. Thank you.

The Chair recognizes Mr. Parris.

Mr. PARRIS. Thank you, Mr. Chairman.

I want to add my words of congratulations to you for holding this hearing today, and welcome the witnesses. Mr. Chairman, the problems of FSLIC very much deserve our attention.

As some of you may recall, I have been somewhat outspoken on the need for the committee to address the problems of FSLIC for more than the last 3 years. Last year, the committee did take action, applied what we call the FSLIC recap, what is now known as H.R. 27.

However, the market forces in the delivery of financial services in this Nation have simply overwhelmed the regulatory capacity of government, and the situation changes almost daily in very profound ways.

In the last several weeks, I have talked to a large number of leaders in the thrift industry, and what I hear from these experts is an increasing realization that the FSLIC recap plan similar to that adopted in the last Congress could pose a serious threat to the solvent thrifts in this Nation.

I have read the estimates of the financial requirements for the solution to this problem that are far beyond the $25 billion figure that we have used, and may now exceed $40 billion.

The continuation of the program of having our healty S&Ls bail out the failing institutions could jeopardize the whole industry, and create a crisis of considerable proportions with enormous and international implications and consequences.

An attempt to consider and even summarize the FSLIC problem and the changes taking place in the thrift industry alone even in several hours of hearings is very much like trying to summarize war and peace in 5 minutes.

Nevertheless, I have the sense that this committee may be on the verge of reenacting legislation that is intended to save the thrift industry, but may only buy time and ignore the real problems of the changing marketplace for the delivery of financial services in this Nation.

I suggest to you that many others on this committee have a number of reservations about whether or not this is the best or even the complete solution to the problem. I would urge my colleagues, therefore, to proceed with caution, as some fundamental rethinking about the future of the thrift industry is, in my view, in order.

We should use these hearings as an opportunity to debate, discuss and to get some of these very complex questions answered rather than simply review and enact one of the several legislative proposals that are before us.

I look forward to the opportunity of doing that in these hearings, Mr. Chairman, and I thank you.

The CHAIRMAN. Does anyone else seek recognition at this point in time?

Mr. Kleczka has an opening statement.

Mr. KLECZKA. Thank you, Mr. Chairman.

Mr. Chairman, if Congress approves a bailout of the Federal Savings and Loan Insurance Corporation, as seems likely, I would hope that no one, in this room or elsewhere, is encouraged to believe that our Federal deposit insurance problems have been resolved.

Real resolution of our deposit insurance crisis must include a merger of our Federal deposit insurance funds.

I am drafting legislation which will do just that. We may not be able to achieve a merger of deposit insurance funds in this Congress, but I am convinced that we should lay the groundwork.

To do otherwise would mean opting for a quick, short-term fix at the expense of a long-term solution. Mr. Chairman, I would ask unanimous consent that my complete statement be included as part of the record.

The CHAIRMAN. Without objection, it is so ordered.

[The prepared statement of Mr. Kleczka can be found in the appendix.]

The CHAIRMAN. The committee will now hear from Gerald J. Levy, immediate past chairman of the U.S. League of Savings Institutions. He will be followed by Mr. David J. Sullivan, Jr., treasurer of the National Council of Savings Institutions, and Patrick Forte, president of the Association of Thrift Holding Companies.

Mr. Levy, we will put your entire statement in the record, and you may proceed to summarize.

STATEMENT OF GERALD J. LEVY, IMMEDIATE PAST CHAIRMAN, U.S. LEAGUE OF SAVINGS INSTITUTIONS, ACCOMPANIED BY W. W. McALLISTER

Mr. LEVY. Chairman St Germain and Members of the committee, my name is Gerald J. Levy. I am president of Guarantee Savings of Milwaukee, and appear today on behalf of the U.S. League of Savings Institutions, where I am immediate past chairman, and have chaired a special task force to address current issues confronting the FSLIC.

I am accompanied by W. W. McAllister of San Antonio Savings in Texas, who headed our subcommittee seeking constructive steps to combat the special problems affecting our member institutions operating in depressed economic areas.

Together with our written statement, we have submitted the final copy of our task force report. The report was adopted unanimously by our Board, which consists of directors from every State. I believe our Board is as representative a group as it is possible to convene of institutions ensured by the FSLIC, the audience most directly affected by legislation to recapitalize the deposit insurance fund.

We appreciate the priority this committee places upon the current financial problems of the FSLIC. The situation has changed somewhat since the legislative proposals of last year. Most notably, it is clear that economic conditions vary significantly by State and local community.

We found that the FSLIC caseload has become intertwined with the deepening economic depressions in various States, which are creating major difficulties for both savings institutions and commercial banks.

You can see from the maps displayed before you a considerable similarity between States with economic problems, commercial bank failures, and savings and loans with earnings problems.

The new situation requires a more flexible approach to the FSLIC's problems. The U.S. League proposes a two-pronged savings institution self-help plan, self-help because it will restore the health of the FSLIC and well-managed institutions operating in depressed economies, without turning to the taxpayer, without enlarging the Federal deficit or calling for Treasury funds or guarantees.

The first part involves a regulatory and supervisory approach to extend capital forbearance, and to adopt generally accepted accounting principles for problem loans of well-managed institutions operating in depressed areas.

We have explained our suggestions to Chairman Gray at the Bank Board. Experience demonstrates that time can heal wounds, especially where the institutions involved hold assets consisting primarily of loans secured by real estate.

The forbearance suggestions of our report are very important to the health of the FSLIC, but permit me to focus on our improvements to the legislative plan developed by the Treasury. We suggest two years of bond issuance of up to $5 million to provide upfront resources of the FSLIC while the Treasury proposal asks for $15 billion.

Repayment on the bonds under our self-help plan would come first from the dedication of the statutory 20 percent net income setaside of the Federal Home Loan Bank System, rather than a $3 billion initial drain on the retained earnings of the system as recommended by Treasury.

Adjustments would be made to treat home loan banks with FDIC insured Members on an equitable basis. No one, the U.S. League or the Treasury, can forecast with accuracy the needs of the FSLIC in the years ahead.

We have supported in large part regulatory steps such as broker deposits, direct involvement and phased-in higher capital rules to contain future problems. We applauded the chartering of FADA to accomplish asset disposition in a business-like way and in the use of the management consignment program.

The managerial strains on the FSLIC are considerable. Turnover at the policy level, staffing deficiencies, and also hedging strategies at institutions with the consent of the Bank Board open the question.

The U.S. League believes the prudent approach is to limit the extraordinary up front bond issues to 2 years, at which point Congress can review the project. By leaving in place the home loan banks' retained earnings, there is flexibility for future borrowing at that point.

Our plan provides essentially the same resources to the FSLIC over the next 2 years as the Treasury version. It provides significantly more over the long-term, because the FSLIC would not be burdened with paying interest on two or three times as much borrowing.

We are pleased to see that H.R. 27 retains statutory language giving some hope that the extra one-eighth of one percent FSLIC special assessment can be phased out. Not only is the special assessment an extra competitive handicap, but together with the

prospect of debt service on $15 billion in bonds, it encourages stronger institutions to migrate from the FSLIC to the FDIC.

H.R. 27 also contains important provisions correcting a problem with the FSLIC secondary reserve. It also establishes an industry oversight group and assures periodic reports to this committee and your counterpart on the other side of the Capitol.

Our written testimony explains once again why plugging the nonbank bank loophole is important to conserving the resources of the FSLIC, and asks your help with your colleagues on the tax-writing committee for extending sunset dates on special code provisions essential to attracting bidders for supervisory mergers.

Finally, you should be forewarned that testimony you will hear tomorrow from the Treasury witness may attempt to ridicule our good faith effort for a self-help plan sustainable by our industry. We wish to reserve the right to file a point-by-point rebuttal of such testimony.

I would now turn to the Treasury plan itself and the problems that we have with it. We are concerned about the sheer dollar volume——

The CHAIRMAN. Mr. Levy, I think maybe we ought to get unanimous consent for your request that you just made. The request is that subsequent to Treasury's testimony, if necessary, Mr. Levy, on behalf of the U.S. League, would appreciate the opportunity to be able to file a rebuttal statement.

Is there objection? The Chair hears none. The gentleman may proceed.

Mr. LEVY. Thank you.

Turning to our problem and our departure from the Treasury plan, our concern is with the sheer dollars involved in the plan, $15 billion. We believe that this could lead to a too-rapid level of expenditures, and we are deeply concerned about the impact it would have on the depressed real estate markets that we referred to in the charts.

The concern is that with that kind of cash on hand, it is very conceivable that we could move towards almost a fire sale mentality in dealing with the real estate in that area.

I know that statements have been made about the concerns with withholding and losses that have incurred to the FSLIC by hanging on.

I might point to the GAO report which came out in September which pointed out that by holding back from 1982 to 1986, the FSLIC actually saved $4.7 billion by being the beneficiary of the drop in interest rates and the improvement in the spread problem cases that we saw.

We suggest that there should be a go-slow procedure in dumping real estate in these depressed areas.

We are moving at the bottom of the market in areas like Texas, Louisiana, and Oklahoma, and we are deeply concerned about the process moving forward too quickly.

We are also concerned about the impact of the tax reform bill, and the elimination of the tax-free reorganization that sunsets in 1988.

This is going to compel a much more rapid disposition of case resolution, and we are concerned that with this in place, and with

the $15 billion access to the marketplace, it might compel a bonding level that would just be one that the system could not handle, so we ask for your assistance in getting an extension on the tax-free reorganization for an additional 3 years. This makes it possible to put together the supervisory mergers.

What we have tried to address in our plan, and I think it is apparent from it, is an attempt to keep all present members of the FSLIC on board.

I alluded to the fact that there are some members who are well capitalized publicly held companies that would consider alternative insurance, namely, the FDIC.

Our hope is to keep all of those people within the system, because all of the plans, the plan filed by the Treasury and our plan, really require the cooperation and involvement of all savings and loans, and we certainly can't see the departure of the healthy institutions moving across the FDIC and being able to fund out and carry out either plan.

We are certainly pleased that the proposal on the table calls for a phasedown of this special assessment. I think it is important to note that if you look at the Treasury proposal for some $3 billion in funding, the annual interest costs will run about 1-1/2 times the regular assessment, so we believe that it is going to be very difficult, if not impossible, to ever phase out the special assessment, if we move to a level of bonding at $15 billion, so that certainly increases the pressure on those well capitalized public institutions that we would like to keep from making an alternative decision.

There is some other uncertainty that I would like to put back on the table, the uncertainty that we have generated by the instability of the Board, the instability of the FSLIC.

We are now in the second year of operating with a temporary director of the Federal Savings and Loan Insurance Corporation.

We have been extraordinarily lucky over the past year to have two temporary directors who have performed brilliantly. But to have a problem of this size, and to be putting this amount of money on the table, and not having a permanent director in place is really of deep, deep concern to us.

Added to that, the instability of the Board and the potential changeover, the need for filling permanent positions, all of these things we think are creating uncertainty on the part of our Members, and we think within the 2-year period that we propose funding, that these things can be resolved, and we can satisfy our Membership and keep them on board and keep them within the plan.

One last point, and that is the announcement that came out from the Mayflower Group. We have supported continually the closing of the non-bank bank loophole because it directly ties to the size and solution of the problem, and we now have on the table the support of the Treasury of this Mayflower Group plan which, in effect, would eliminate, if carried through, any possibility of closing that loophole.

That, again, creates uncertainty, because it raises a question in our minds of what kind of resolution in terms of supervisory mergers, of takeovers by the supervisors that could be accomplished without that loophole being closed, so we think it is very important

to keep attention focused on that, because it is definitely part of the overall cost and solution of this problem.

Thank you very much.

[The prepared statement of Mr. Levy can be found in the appendix.]

The CHAIRMAN. I will call upon Mr. McKinney to introduce our next witness.

Mr. McKinney?

Mr. MCKINNEY. Mr. Chairman, it gives me great pleasure to introduce the next witness, David J. Sullivan, Jr.

I could probably tell you how far back we go, but that would embarrass both of us. I will simply put it this way: When we were both appointed directors, he as a lawyer and myself as a small businessman in Mechanics and Farmers Savings Bank in Bridgeport, we were their token kids. Now he is no longer a lawyer, but the chairman of the bank, and here to represent his industry in the halls of the 100th Congress in Washington, DC.

We got paid a great two crisp 20 dollar bills for our directors' participation and every loan of over $400,000 on real estate had to be approved by the entire board, as I remember it, so that gives you a guesstimate about how long ago it was, and we will leave it at that.

It is very nice to have David here. He has been a good friend. He has been a good help politically, and he has taken the Mechanics and Farmers Bank and turned it into a sound growing, healthy institution with assets. Having started both of us when a savings bank didn't advertise, didn't have carpet on the floor and, God help you if you went on the radio; we are in a new world.

Thank you, Mr. Chairman.

The CHAIRMAN. Where did you go wrong?

Mr. MCKINNEY. Well, that is a good question. I picked applications and no money. He picked banking and money.

The CHAIRMAN. Mr. Sullivan, we will put your entire statement in the record.

You may proceed to summarize.

STATEMENT OF DAVID J. SULLIVAN, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, MECHANICS AND FARMERS SAVINGS BANK, FSB, BRIDGEPORT, CT

Mr. SULLIVAN. Thank you very much, Mr. Chairman and Mr. McKinney.

Mr. Chairman and Members of the committee, my name is David J. Sullivan, Jr., president and chief executive officer of the Mechanics and Farmers Savings Bank, FSB, Bridgeport, CT.

I am appearing today in my capacity as treasurer of the National Council of Savings Institutions, a trade association representing approximately 600 savings banks and savings and loan associations with total assets of $450 billion. Our Members include both FDIC and FSLIC-insured institutions.

Our bank, the Mechanics and Farmers Savings Bank, is an FDIC-insured institution and a member of the Federal Home Loan Bank of Boston, and under the provisions of the Garn-St Germain bill, we are a federally chartered savings bank regulated by the

Federal Home Loan Bank. I am currently privileged to serve as a member of the board of directors of the Federal Home Loan Bank of Boston.

We are very pleased to accept your invitation to testify at today's hearings, and we support your initiative in moving quickly to bring the subject of FSLIC recapitalization before the Banking Committee.

I would like to begin by briefly reviewing the current state of the industry in order to establish the economic and financial framework against which our member institutions evaluate FSLIC recapitalization. Ninety-eight percent of the council members are operating profitably; and for most of these institutions, their earnings are at a record high.

The council's research department estimates that 1986 will be another record profit year for FDIC-insured savings banks. As a result, capital margins have increased dramatically in the last year, and we expect 1987 to indicate further positive results along this trend line.

Average capital at FDIC-insured savings banks was 7.3 percent as measured by generally accepted accounting principles, and savings bank capital positions have recovered fully and have now returned to the historic levels that prevailed prior to the extreme financial stress of the early 1980s.

In fact, Mr. Chairman, as you know, in the Northeast and particularly in New England, return on average assets of 100 to 150 basis points is quite commonplace.

On the savings and loan side, the economic picture shows similar earnings and capital improvement, as well as the traditional, more positive deposit growth.

On the negative side, there continue to be close to 400 FSLIC-insured institutions which have not been able to take advantage of the lower interest rate environment due primarily to problems relating to asset quality.

These institutions are concentrated in those areas of the country which have been hurt by the price decline in oil and by agricultural problems.

Notwithstanding these regionalized problems, we estimate that 1986 will be another year of strong profits for the majority of savings and loan associations and that the industry will continue making major strides in rebuilding its net worth.

While FSLIC-insured institutions, in the aggregate, are thriving, the conditions of the insurance itself is going from bad to worse. I don't need to elaborate on that.

The comments that you made, Mr. Chairman, and Mr. Wylie made in the opening statements, clearly spell that out.

This being the case, the basic public policy question confronting the Congress is whether the shortfall in current FSLIC reserves should be made up by the healthy segment of the industry or the government itself.

The national council was the first to suggest a solution somewhere in between—namely, a private/public partnership that would utilize the resources of the Federal Home Loan Banks as the lever for generating new funds for FSLIC.

Unfortunately, this suggestion was not favorably received by either the FHLBB or the regional banks when it was initially made in early 1985.

Responding to a congressional directive, the Treasury Department began in 1986 to develop a borrowing program premised on a capital contribution of up to $3 billion from the Federal Home Loan Banks. These funds would be used to establish a financing corporation which would support as much as $15 billion of capital market borrowings.

Under the terms of the plan, these borrowings would then provide equity funds to FSLIC for use in disposing of failed institutions.

In response to objections by the Congressional Budget Office, the original plan was modified in order to avoid any budgetary impact by empowering the financing corporation to assess FSLIC-insured institutions to service its capital market debt, while FSLIC's assessment would be correspondingly reduced.

In June 1986, our national council's task force studying this issue recommended support for the Treasury/FHLBB plan with certain changes, and both the Treasury and the Congress were generally responsive to these suggestions when the bill was being debated last year.

On January 12, 1987, we convened our task force and after considerable discussion and examination of a number of different options, it was agreed that the council should continue to support the Treasury/FHLBB plan.

In fact, Mr. Chairman, we consider this question of recapitalization of the Federal Savings and Loan Insurance Corporation so essential that we are now prepared to support immediate enactment of the FSLIC recapitalization measure regardless of whether our recommendations are addressed now or deferred for subsequent consideration.

We take this position because the indisputable fact is that in the absence of any new infusion of new capital, FSLIC will be unable to deal with its current, let alone future, case resolutions.

The anticipated cost of this effort is known to be at least $10 billion in 1987, with the eventual figure rising in fairly short order to $25 billion. This is not an amount which can be met through current and special assessments and earnings on reserves. Nor is it an amount which can be handled in a business-as-usual method.

The clear message we would like to leave with the committee today is that resolution costs have already been stretched out far too long and in too many cases.

The real risk of inaction is that the healthy section of the thrift industry which I have described will be irreparably injured by the inability of the FSLIC to handle its current problems.

We estimate, for example, that the costs of generating deposits as an FSLIC-insured thrift is approximately 50 basis points higher than the cost of raising liabilities for a similarly situated FDIC-insured bank. This disparity is largely the result of the perceived weakness of the FSLIC fund in too many cases.

As a final comment on the new provision of H.R. 27 that would subject the Federal Asset Disposition Association to GAO review, I would state that the national council supports this change.

Although FADA has not taken title to any property under its present business operations, public scrutiny of this type would benefit all the parties concerned.

Mr. Chairman, the fact that the hearing is being held today on the same bill, with your improvement, that was passed last year, your statement of January 6 on the floor in which you list the recap bill as the first priority, the fact that this hearing was scheduled so early in the legislative session, and with just this one subject, indicates to us that the committee is fully aware of how important FSLIC recapitalization is, and we support the committee in that position.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Sullivan.

[The prepared statement of Mr. Sullivan can be found in the appendix.]

The CHAIRMAN. Now we will hear from Mr. Patrick Forte, who is President of the Association of Thrift Holding Companies.

STATEMENT OF PATRICK A. FORTE, PRESIDENT, ASSOCIATION OF THRIFT HOLDING COMPANIES, WASHINGTON, DC

Mr. FORTE. Thank you, Mr. Chairman and Members of the committee.

Our Members are keenly aware of the need to improve the financial position of the FSLIC.

With an estimated primary reserve of $1.9 billion, the FSLIC——

The CHAIRMAN. Mr. Forte, unfortunately your voice isn't carrying through that mike. You are going to have to get real close to the mike.

Mr. FORTE. With an estimated primary reserve of $1.9 billion, the FSLIC is confronted with potential payouts of possibly $25 billion. This disparity threatens not only the thrift industry and the consumers who rely on it, but the Nation's economic health.

We believe this problem must be dealt with as soon as possible. A major recapitalization plan with wide support must be agreed on so the thrift industry can regain the public confidence it desperately needs.

Delays in dealing with the problem will increase the ultimate costs to the insurance fund and clearly present the possibility of a taxpayer-assisted plan.

I want to emphasize to this committee that the problem we are facing has not been caused by mismanagement within the thrift industry, in only a handful of well publicized cases has capital depletion derived from management malfeasance.

The primary drain on the FSLIC resources can be attributed to the inability of the thrift industry to build or to raise capital because of corporate structure, dislocations in the economies of certain regional areas, inadequate management, and the lack of regulatory foresight.

As to regulatory foresight, for example, in the last year, the Bank Board has created havoc within the thrift industry by significantly changing the rules for evaluating industry assets.

The combination of its new classification of assets rule and its R-41c memorandum governing the appraisal of assets has severely impaired thrift industry operations.

The classification of assets regulation allows Bank Board examiners, functioning with virtually no objective Board guidance, to write down assets at their own discretion.

The R-41c memorandum, moreover, will require immediate and substantial writedowns, often producing values far below those that would result from applying generally accepted accounting principles.

Put another way, by writing down industry net worth to a degree not required by generally accepted accounting principles, the Board has made even more urgent the need to pass a recapitalization bill.

Without a major effort to improve the means by which thrift institutions can be themselves capitalized, the ongoing cost of deposit insurance will become an increasing burden on those thrifts which are now well capitalized.

In other words, the strong thrifts will indirectly pay an increasing subsidy to the weak thrifts, which will in turn weaken thrift earnings and hamper the building of capital through retained earnings.

This is the principal reason Members of our association believe the FSLIC recapitalization addresses only a small, albeit pressing, aspect of the larger problem of undercapitalized thrift institutions. Regardless of the financial strength, the FSLIC alone cannot solve the problem.

Further, it should be noted that in addition to the FSLIC, and thrift depositors and taxpayers, there are a great number of individual investors who have a great stake in this industry.

Over the past 4 years, investors have provided $14.2 billion to thrifts.

During 1983, there was an investment of $3.5 billion; in 1984, $800 million; in 1985, $2 billion; in 1986, $4.6 billion, a total of $10.9 billion of additional equity through stock purchases.

In addition, during the same period, investors have provided $2.3 billion in the form of subordinated debt, another form of capital.

Without this infusion of capital, the distress of the FSLIC and the industry would have been further exacerbated. Therefore, the interest of these public investors must also be considered by the Congress in insuring the viability of the FSLIC.

On behalf of the Members of our association, I ask this committee to look beyond the immediate needs of the FSLIC and to consider at the earliest opportunity measures that will set about improvements to statutory and regulatory programs that will have the effect of encouraging further private capitalization of the thrift industry.

Some of those concerns which we have, that have ramifications that go beyond the affected holding companies, include, first, the limitations now imposed on transactions with affiliates. This restriction effectively prohibits thrift holding companies from establishing financing subsidiaries which make mortgage loans that are to be sold to affiliate thrifts. This and other affiliate transaction rules applicable to thrifts must be modified to reflect present day realities.

Second, the elimination or relaxation of debt-control restrictions, to encourage restrictions, to encourage additional capital flow into the thrift industry, the restriction must be lifted on the amount of non-diversified thrift holding the amount of debt, non-diversified thrift holding companies and non-thrift affiliates can incur without prior written approval of the Federal Home Loan Bank Board.

Third, expansion of permissible thrift-related activities, including cross-marketing of products or services. Thrift holding companies are already sufficiently insulated from the insured subsidiary deposit institution to which the Savings and Loan Holding Company Amendments of 1967 envisioned the holding company would serve as a source of strength.

With specific regard to H.R. 27, we are in general agreement with the major items in terms of the bill. We applaud the committee for working in this direction with the reintroduction of the FSLIC recapitalization concept widely considered in the previous Congress.

Industry support of the bill will be enhanced if language is included which provides clear standards whereby the special assessment can be discontinued without relying on the discretion of the Bank Board.

Our association also agrees with these elements of H.R. 27.

First, we believe the scale of the proposed recapitalization is appropriate to the magnitude of the problem. Despite the price tag of the solution, and the consequent indirect cost to our Members, we agree that public confidence in the deposit insurance fund can best be restored through a large injection of capital.

Second, H.R. 27 will draw on surplus funds of the District Federal Home Loan Banks without creating risk contingencies that could threaten their future stability. This is in contrast to a recent alternative proposal which could ultimately undermine the capital base of the whole thrift industry.

H.R. 27 provides a remedy for the FSLIC which does not impose an inequitable burden on stockholder-owned thrift institutions, as would seem to be the effect of each alternative proposal we have seen. We believe the future of the thrift industry will be dominated by those institutions with capable management which can attract new capital investment that will come from community investors and from those who invest in publicly traded thrifts.

H.R. 27 will establish a substantial reservoir of financial strength at the insurance level, which in turn allows thrift managers, depositors, and those who may wish to inject additional capital into thrift institutions to rely on the fund as a source of stability. This bill will achieve this stability without drawing on the American taxpayer for a bailout.

To enhance the prospects for approving a plan to recapitalize the FSLIC, we strongly believe that the recapitalization bill that goes forward should not include other issues.

In the Chairman's letter requesting our testimony here today, he noted that several Members have indicated an interest in proposing amendments to H.R. 27 to deal with limitations on direct investment.

The Bank Board is, of course, in the midst of an ongoing process designed to evaluate its 2-year experience with the current direct

investment rule. It has received comment on that experience and is conducting public hearings later this month. The Board, we believe, is carrying out precisely the rule-making function for which independent regulatory agencies are designed.

The Board has committed to a schedule for developing a final rule on direct investments by March 15. There can be little doubt that some rule limiting direct investments will be adopted at that time.

Both Chairman Gray and Board Member Henkel have indicated support for a proposal to limit direct investments, though they differ as to the appropriate method.

Further, Board Member White simply has not stated his position while reviewing the evidence.

The Board is carrying out its rule-making function in a responsible manner. It has opened its process to an unprecedented degree of public participation. We believe that, through this process, they can develop a rational and workable standard for regulating direct investment activity and provide appropriate protection for the FSLIC fund.

There is no reason for Congress to preempt the Board's efforts.

If, after the Board has taken final action, the Congress is not pleased with the resulting rule, there will be ample opportunity to legislate at that time.

Mr. Chairman, in conclusion, I wish to emphasize one more point, and it is our belief that the most significant cause of thrift industry problems today is not any particular kind of investment, but rather the regional economic crises that are being experienced in several parts of the country today.

While direct investments have contributed to thrift industry failures, so have many other forms of investment, traditional and untraditional alike. The truth of the matter is that any area of investment activity can be mismanaged, can be subjected to fraudulent conduct, or can fall victim to a regional economic crisis.

The recapitalization problem is of such paramount importance that its consideration by the Congress should not be diluted by discussion of other matters, and Congress' attention to this problem should not be diverted to other issues which should be addressed separately.

Mr. Chairman, thank you. We appreciate your consideration of our points of view.

[The prepared statement of Mr. Forte can be found in the appendix.]

The CHAIRMAN. Thank you, Mr. Forte.

Mr. Wylie has a brief statement to make.

Mr. WYLIE. Thank you very much, Mr. Chairman.

As you know, the Republican Conference meets at 11 o'clock today to approve ranking Members and committee assignments. We are not really the jury yet, if you please. Your meeting was called first and there wasn't anything I could do about the conflict.

Our Members need to go to this important meeting. We do have some questions and hopefully will return before the hearing is concluded. If not, we would like to submit something for the record.

Mr. FRANK. I thought we could vote on something.

Mr. WYLIE. You vote on us and approve us?

The CHAIRMAN. Barney says we ought to vote on something, since you are not the jury.

Thank you, Mr. Wylie.

Mr. Sullivan agrees with the addition of asking GAO to watch over FADA. Does the U.S. League have any problem with that, Mr. Levy?

Mr. LEVY. I don't think we have had a chance to really establish a position. We are not opposed to public scrutiny of this fund.

The CHAIRMAN. Would you, for the record, submit a statement to that effect?

Mr. LEVY. Yes, we will.

[The position statement to be furnished can be found in the appendix.]

The CHAIRMAN. Mr. Forte?

Mr. FORTE. Yes, sir? The question?

The CHAIRMAN. The question is with respect to FADA and the GAO oversight of FADA that has been added to the bill. Do you have any problem with that?

Mr. FORTE. No, sir.

The CHAIRMAN. Mr. Levy, in your statement and in your plan, you refer to zero coupon bonds. I know for a fact that it has been suggested to your task force that you obtain the services of some security experts to give an opinion as to how marketable these zero coupon bonds would be.

To the best of my knowledge, you haven't done that, have you?

Mr. LEVY. No, we have not.

The CHAIRMAN. Are you going to do it?

Mr. LEVY. Yes, we are.

The CHAIRMAN. Will that be done expeditiously so we will have the benefit of this for our deliberations?

Mr. LEVY. Yes. We will bring that forward as quickly as possible.

The CHAIRMAN. We did suggest that a long time ago.

[The opinion on zero coupon bonds referred to can be found in the appendix.]

The CHAIRMAN. Now, Mr. Sullivan of the National Council of Savings Institutions has suggested that the institutions be allowed to leave FSLIC provided they have an exit penalty of 2 years of regular premiums plus 2 years of special assessments.

On page 4 of your statement, Mr. Levy, you recognize the problem of FSLIC-insured institutions switching to FDIC.

Now, what is your position on the national council's proposal to impose exit penalties in these situations or to construct a Berlin Wall to prevent such switching?

I ask you, Mr. Levy, to comment, and then Mr. Sullivan, I ask you also to tell us, and this will be the end of my questioning, how you arrived at this 2 years of regular premium plus 2 years of special assessments, you know, where that came from?

Mr. Levy?

Mr. LEVY. Specifically, we oppose the so-called Chinese Wall. We think there should be the ability to depart if an institution so chooses. We have generally supported the concept and development of some reasonable exit fee. We have not gotten specific on what that amount is.

We have heard it as the 2-year range and we have heard some that have reached levels that we would consider almost the imposition of a Chinese wall. I don't think we would have difficulty with the National Council's position of a 2-year imposition.

The CHAIRMAN. Mr. Sullivan, could you give us the justification or the rationale behind your proposal?

Mr. SULLIVAN. Yes, Mr. Chairman. I believe that historically the statute spoke of a 2-year penalty if, for instance, an institution went from a federally insured status to a State-insured status such as we had in Massachusetts or Maryland, and we simply use that as a historical precedent, since we did not really have any other basis to go on. It seemed to be a reasonable substitute for some of the uncertainty that has been about now concerning the price of moving from one fund to another.

The CHAIRMAN. But, Mr. Sullivan, things have changed. Everybody agrees that action has to be taken; the situation is critical. Yet, you are harkening back to days of yore rather than what I am asking, which is: What statistics—do you have statistics?

Mr. SULLIVAN. No, sir.

The CHAIRMAN. You are going upon historic precedent. Unfortunately, sometimes history is not precedence.

Mr. SULLIVAN. You are very correct, Mr. Chairman. We took that as something that has a current statutory basis, and it seemed like a reasonable compromise. But we are not wedded to that figure.

The CHAIRMAN. Do you suppose that you might use the expertise of your counsel, and give us a little more than a historic precedent, but some actual hard numbers to look at?

Mr. SULLIVAN. We will be happy to take up that question.

The CHAIRMAN. That would be helpful, and the U.S. League might want to do something like that, too.

Mr. SULLIVAN. Yes, we will.

The CHAIRMAN. Mr. Gonzalez.

Mr. GONZALEZ. I want to thank the three witnesses for taking the time to appear before us on a very critical matter.

I would like to know if it would be possible or feasible to have Mr. McAllister tell us a little bit about the very excruciating and clear danger that exists in the Texas area, and particularly coming from a man who represents the largest institution in our State of Texas and happens to be headquartered in my district, in the 20th Congressional District, of San Antonio.

We do have very singular, peculiar problems that need very special attack or attention. And if Mr. McAllister could, it would be a big favor.

The CHAIRMAN. Excuse me just a moment.

Mr. GONZALEZ. We have to get permission.

The CHAIRMAN. Is there objection?

The Chair hears none.

Mr. McAllister is recognized.

Mr. MCALLISTER. Texans are always willing to talk.

The basic problem we have experienced in the last year and a half is an unprecedented thing in that it has manifested itself in unusually high levels of foreclosures. And Houston is in worse straits than any major city in the country.

During 1986, actual foreclosures—not just postings—reached a level of 24,000 homes in Houston. And in the month of January we had that level at a 3,000-home level, which was even higher than it had run in 1986.

We feel a major part of our plan is the forbearances we ask of these institutions which, in turn, would pass through a tremendous benefit to the citizens in these areas where our economies are impacted by the decline in oil prices and other regional factors. Our plan requests a pattern similar to what the banking regulators have done for the national banks where they have dealt with the problems in agriculture, and also the energy problems.

We think this is a very important cost consideration, also, because it is our hope that these forbearances would leave a substantial portion of this depressed real estate in hands that appeared stronger, and perhaps let us weather it through until the economy strengthens a bit. And then we address the problems in those institutions and liquidate those assets at a substantially reduced loss. But that is a very important part of the U.S. League's Program.

A surprise to those of us in Texas are the charts on the wall, and there are 14 other States that are experiencing similar problems.

Mr. GONZALEZ. Would you care to comment on the complaints that I have had, from a very substantial number of savings and loan and banking sources in Texas, that the regulatory agencies are in fact red-lining Texas at this time and in this critical period, in that it is prejudicial to helping the institutions rather than insistence is made on really in effect liquidating rather than trying to help? Is there any substance to that?

I have had numerous complaints from various portions of the State.

Mr. MCALLISTER. The major problem we have seen is the method of evaluation of troubled assets. In our report, we request they do use the GAAP process rather than the harsher evaluations implied in the 41(c). The R-41(c) approach uses a very high discount figure, and in a number of appraisals I have seen it has been a 12½ to 14 percent level of discount.

In contrast, the NRP approach uses a discount that is the institution's cost of money.

The difference in these two discount figures can make a tremendous difference in the recognized loss an association takes in the initial portion of the troubled loan.

The procedure that we recommend is identical to that procedure used by the banking regulators, and we feel that our regulators' failure to adopt these more lenient approaches to the initial evaluations is hurting our institutions.

Mr. GONZALEZ. My time has expired.

The CHAIRMAN. Mr. Neal.

Mr. NEAL. Last week, I had occasion to talk to Ed Gray, and there were a couple of institutions in my area working on a merger, and one of them had asked me to contact him to speed up the procedure. During the course of the conversation, we started talking about this approach, and he made the point that this whole plan was contingent on a satisfactory exit fee.

He made the point that you are going to the capital markets to sell these instruments, and if investors see how the money is going

to be repaid, and in fact if healthy institutions could leave the system at will with no penalty or very small penalty, that investors won't be inclined to buy these instruments, and therefore the whole plan would fail.

Would you agree? Please comment.

Mr. LEVY. The question was raised by the Chairman about exit fees, and there are two ways to look at this—actually, three. You could build a wall and say nobody could leave. You can set a fee and say you can't leave unless you pay a certain level of fee. We tried to move to an entirely different approach and put together a plan to sell to our Members, so that they would stay on board, look at the plan and do an analysis of the costs, the kind of review process that will take place and build a comfort level so they stay.

What we have done with our 2-year plan is essentially that. We have run it past a few people in the industry that show the strongest tendencies to move on, and they are comfortable with the approach.

I underscore again that the Treasury plan brings on a level of debt service that will require an ongoing special assessment virtually forever. With that kind of analysis necessary, one starts equating what is the cost of staying versus leaving, and you get caught up in the exit fee question.

We do keep our people on board, and we don't have them analyzing exit fees.

Mr. NEAL. No guarantee under your plan?

Mr. LEVY. No guarantee that we can develop an exit fee that somebody won't analyze and say, in the final analysis, it is still a question; you are still better moving on. We are struggling trying to reach an equitable conclusion.

Mr. SULLIVAN. The marketplace, in my opinion, is very pragmatic, and in evaluating these securities they are going to look at the sources of repayment. And, without some restraint on institutions that want to leave, Mr. Gray's—Chairman Gray's position is well-taken and one that has to be addressed. And that was part of our position on the exit fee.

As the Chairman raised the question earlier, there is a case in Florida—not yet docketed on the appellate level, and it has some other wrinkles to it—but there they said the exit fee was totally illegal. It had in part to do with the timing when the regulation was issued or the position the FHLBB took.

The market will look, in evaluating these securities, at how the instruments are going to be funded and repaid, without taking into consideration what might happen down the road. They are going to want to see what is there and what will be done to protect the income stream.

Mr. NEAL. What is your idea of a reasonable exit fee?

Mr. SULLIVAN. We had a 2-year proposal in our testimony, and at the Chairman's request we are going to research that further and submit our recommendations specifically with statistical background on that question.

Mr. NEAL. Mr. Gray was suggesting a fee based on an assumption that a thrift institution would be profitable and grow at 5 or 8 percent a year, and that a reasonable exit fee would be what a

thrift would have paid in for 10 or 8 years under those assumptions. That is a larger amount of money.

Mr. SULLIVAN. Substantially larger, yes, sir.

Mr. FORTE. Mr. Neal, on the question of the exit fee, I don't think from the viewpoint of an operator company a special assessment is the only incentive to consider exiting the fund. There are other considerations, very real considerations, of dealing with the Bank Board on a business basis that gets into many other matters of trying to run a public company, and it drifts into questions of processing applications and the matter of running your business that many companies are beginning to consider in the range of as important as the exit fee, to lead them to think of leaving the fund.

As to an exit fee itself, we certainly understand there should be an exit fee. Why have no idea at this time what that fee should be, but it should be connected in some way—some consideration that the operating company has received from the FSLIC.

The CHAIRMAN. Mr. LaFalce.

The Chair is going to call upon Members according to their arrival times, for a 5-10 minute period. That helps the new Members participate in return for their timely appearance.

Mr. LAFALCE. You are appearing on behalf of the National Council, and you heard the U.S. League espouse a position somewhat different from the National Council, and by the administration, and passed by at least the House Banking Committee in the last Congress.

What do you think of the relative merits of (a) the bill passed by the last Congress, or by the House Banking Committee in the last Congress, which I believe the National Council signed off on (a) the League's first preference; and (b) the League's second preference, which would be some type of merger?

Mr. SULLIVAN. In my closing remarks, I tried to state our position, and that is, since the committee and the House did, in fact, act upon this legislation last year, and since this is the same bill with only the improvement of the GAO supervision of FADA, we think this particular piece of legislation could be acted upon almost immediately. In addition the committee is familiar with it, as is the full House and this is a situation involving the question of consumer confidence that is so essential to our industry. Thus the administration plan is the most expeditious way to at least attempt to begin to solve the problem. We do not think that it is the be-all or end-all; but it is an important beginning, so we support it in that regard.

I have not had time to go over the League's position completely although I have heard my friend, Mr. Levy's testimony this morning. It is a new issue that might have to require further hearings that would involve much more time. I do think that the numbers that are involved in the league plan are not enough to solve the problem.

As far as the merger of the funds is concerned, that is such an involved question with so many ramifications that any attempt to solve or even begin to solve the FSLIC problem by merging the funds would require extensive hearings. It would require tremendous debate, be highly controversial, and in the meantime the problem would grow larger. Time is very important.

Mr. LaFalce. One of your concerns is that the healthy thrifts might leave the FSLIC and depart to the FDIC en masse. Is that something that, number one, is speculative? If it is speculative, what makes you believe it would be true? And if it is speculative, could we deal with that legislatively by either making it more difficult regulatorily, or prohibit it legislatively?

Mr. Levy. It is not speculative, because I have had conversations with managers of large publicly-held companies—and not just large. But it is not an issue that just lies with the large publicly-held companies. There are other well-capitalized institutions that have made expressions to me of the same kind.

One of the things that everybody has talked about is the broad powers in the Thrift Holding Act.

Mr. LaFalce. Could it be dealt with by the FDIC, or isn't it something that could be dealt with by legislative encumbrance?

Mr. Levy. Certainly, you can construct a Chinese Wall and say everybody stays behind the Wall, and contain the problem in that way.

Mr. LaFalce. Or establish a certain set of conditions which would not enable a transfer simply to avoid the additional fees incumbent upon membership in the FSLIC system?

Mr. Levy. Certainly.

We refer to a letter that has been circulated widely, reprinted in the press, from Under Secretary Gould to Chairman Volcker, which says that as the program goes on, if it turns out that conditions change in ways which threaten the viability of the plan, the merger could be considered at that time.

We think the whole question of merger has been put in play and is there. We are not in any way not talking about funding up. Our plan calls for as much money on the table——

Mr. LaFalce. Merger is a separate issue.

Mr. Levy. Totally.

Mr. LaFalce. The difficulty I have with the subject of merger is not so much a conceptual one, although we would have to come to grips with it, but simply a matter of timeliness. We never would be able to bring about a merger of those two insurance funds in a timely manner. It is too drastic a change to do in a timely fashion. And it raises too many fundamental questions, such as what would the future of a thrift as opposed to a bank be?

Would a merger of the two insurance funds—what would it mean? Or is there some way to preserve their identity, et cetera?

Thank you, Mr. Chairman.

The Chairman. The gentleman's remarks are well-taken. The Chair agrees with him as to the fact that we couldn't do this in a timely fashion.

Mr. Barnard?

Mr. Barnard. Thank you, Mr. Chairman.

Mr. Levy, the U.S. League's proposal is in two phases. One is forbearance for institutions in depressed areas. Has any request been made of the Home Loan Bank Board for such a plan that the U.S. League has proposed here this morning?

Mr. Levy. Yes, they had a meeting with Chairman Gray and presented the request for the kind of forbearance that we describe. The forbearance that is being asked for is to parallel the announce-

ments by the bank regulators, the Comptroller of the Currency, and the FDIC, in oil, gas and agricultural areas.

Mr. BARNARD. What has been the reaction of the Home Loan Bank Board?

Mr. LEVY. I didn't attend the meeting, so I don't know.

Mr. BARNARD. Was this the full Board?

Mr. LEVY. No, just a discussion and a presentation of our plan, which included both recapitalization and forbearance, and we think they are very much tied together, because the size of the problem will be in direct proportion to the amount of forbearance granted.

There was a reference to our R41-c, and if you continue to apply it and create the write-down on assets, we can, as Representative Parris provided, we can balloon this thing up to 40 billion, and our concern is providing forbearance at this time.

I was pleased to hear Mr. Sullivan talk about the savings banks and how they have returned to health. Had we marked out whole business to market in 1981 and 1982, we would have put those and many savings and loans out of business, and we returned to health.

We want to give these institutions in these troubled areas a chance to return.

Mr. BARNARD. What is the feeling of the U.S. League as far as the institutions that have been put into conservatorship? That is not a part of your program?

Mr. LEVY. Not at all. We are providing the same number of dollars that the Treasury plan would provide over the 2 years, and we would hope they would move expeditiously to spend that money to deal with the real problem cases.

So far, they have not exceeded a $3.5 to $4 billion annual case resolution. The funds will allow them to move up to $5.5 to $6 billion in a year. We are talking about well-managed institutions that show no signs that cause these problems—excessive growth, mismanagement, fraud. We are not asking for forbearance for those people, but there are well-managed institutions in these troubled areas that are being impacted by the economies in those areas.

And they are entitled to some forbearance.

Mr. BARNARD. I agree. I think the two, the fund and the forbearance, they go hand in hand. How much funds would your plan provide the first year?

Mr. LEVY. We have done a comparison on a 2-year basis. On a 2-year basis we would provide $8.9 billion against $9.6 billion.

Mr. BARNARD. That is without assessing the institutions?

Mr. LEVY. That is with assessing the institutions, and includes the regular premiums, special assessments, and the borrowings.

Mr. BARNARD. And the borrowings——

Mr. LEVY. Would not include earnings on investments.

Mr. BARNARD. Would it be based upon the reserves of the various home loan banks?

Mr. LEVY. The repayment on the bonds would come from the earnings of the Federal Home Loan Bank System, backed up by the savings and loan business. If their earnings were not sufficient, we would pick up the shortfall.

The uniqueness of what we are talking about here, the plan that is being proposed, either of these plans, really involves an industry bailing itself out, the healthy institutions paying for the sick. And

let's not lose sight of the fact that the Federal home loan banks are owned by the savings and loans, so when that money goes forward, it takes money out of another pocket; it is all ours.

Mr. BARNARD. There are 367 thrifts that are now in warehousing. I guess I call that conservatorships. Is it your expectation that if, whatever plan we adopt, Treasury or your plan, will these 367 automatically go on the block?

Mr. LEVY. Well, I am not close enough to those 367. What I would have to do first would be to analyze those 367 and determine how many of those institutions are located in the green areas on the map, and if it could be pointed out that they are on the list because they have been forced to mark assets down to market value, current value, and that in all other respects they have been well-managed. If so, they don't belong on the list.

That is the list they have to attack.

Mr. BARNARD. You don't want to say all have been well-managed?

Mr. LEVY. Not at all. No.

Mr. BARNARD. Mr. Chairman, I would like to state that a GAO study was made in September 1986, last fall, and I quote from page 4, where it says, our simulations predict that FSLIC may lose over $1.4 billion from warehousing 367 thrifts from December 1985 to December 1987, if interest rates do not change over this period.

Moreover, even modest increases in interest rates result in substantially higher costs to FSLIC. Only if interest rates fall do our simulations predict there will be a continued pattern of current savings, so FSLIC, and you will have this, results no other possibility of escalating asset problems, which can only increase warehousing costs, I just add that as another indication of the urgency of this committee and what we do.

The CHAIRMAN. Mr. Barnard's time has expired. I have to go on to other Members.

Mr. Carper?

Mr. CARPER. Thank you, Mr. Chairman, and thank you for your testimony today. At least one of you has touched tangentially on closing the nonbank bank loophole. Would you elaborate on your thoughts on that issue?

Mr. SULLIVAN. The National Council has historically, since the merger of the National Association of Mutual Savings Banks and the National Savings and Loan League, taken the position that we very strongly support deregulation of the financial industry. We have taken the position that we simply do not want to make comments about regulating other segments of the industry because we are looking for as broad and open a competitive market we can. The problem we have is that we do not want to see restrictions or the elimination of the nonbank bank loophole side tied in with some restrictions on our own industry. Therefore we have not taken a formal position on that question, other than to say we are basically in favor of deregulation.

Mr. LEVY. We have been consistent throughout this past year on that question. We think that they are definitely intertwined. You must address the question of the nonbank bank along with the recapitalization.

If entry rights are valueless, if entry into a State can be permitted and has no value, which would be the case if the loophole is not closed, the cost of resolving the FSLIC problem will be significantly higher; so you have to look at it together.

It is clear, as we have seen in some of the cases involving savings and loans and in some of the banks down in Texas, the desire for entry rights has reduced the overall cost to both the FSLIC and the FDIC, so you do have to look at this in a combined way.

Mr. FORTE. We support deregulation in the financial services industry to the extent, to any extent that is not a threat to safety and soundness. We are not trying to inhibit any competitor in the marketplace, so we think also that this issue should not properly be attached to H.R. 27 in that it may inhibit its passage.

Mr. CARPER. Mr. Sullivan, could you help refresh my memory as to why initially two separate insurance funds were created? Are those reasons which are still valid, Mr. Sullivan?

Mr. SULLIVAN. My recollection is that in the period of the Depression and the Bank Holiday of 1933, Congress created the Federal savings and loan industry as we know it today. A separate insurance fund was created, because there was a distinct difference between the commercial banking industry and the thrift industry in those days.

The recognition of the marketplace forces, going right through the Garn-St Germain bill, have certainly modified those distinctions to the point where they are nowhere near as great as they were then. For example in Connecticut, in 1988, State-chartered savings banks will have the same inherent banking powers, as do commercial banks. In summary, my understanding is that the two funds arose out of the separate nature of the businesses that were conducted within the financial industry as a whole.

Mr. LEVY. I agree with that, and you raise the additional question as to now that we are here, where are we going?

One could look at the question of insurance and say it doesn't follow function. In the Canadian system, they have a single deposit insurance corporation that provides insurance, so there are alternatives, and I understand the complexities of raising that, and we are not.

We are trying to provide enough money to get over the next 2 years, and have a chance to take a careful look while they can proceed with the resolution.

Mr. FORTE. If I remember in the 1930s, the establishment of the original two funds, certainly followed the functional lines with FSLIC addressing institutions supporting housing. Today, it would appear that there is a very real possibility that a savings and loan operating purely along traditional lines or investing in traditional activities very possibly may not be profitable through a complete economic cycle.

If that is the case, or that being the case, assuming that, many of the more profitable institutions today are exercising portions of their powers that they received through the Garn-St Germain Act.

That is not to say that there are not still specific advantages to belonging to one system or the other. There certainly are, but there certainly is a clear situation where Members of the FSLIC are not limiting themselves to traditional activities.

Mr. CARPER. Thank you.

The CHAIRMAN. Mr. Forte, you are an attorney. You are great in not answering the question Mr. Carper asked you. He asked you, what is the Council's position on closing the nonbank bank loophole? He didn't say attached to this bill.

This will be my question. What does the Council feel, or what is its opinion on closing out the nonbank bank loophole?

Mr. FORTE. We don't have a position developed.

The CHAIRMAN. Not the Council, the holding companies—excuse me.

Mr. FORTE. That they wouldn't have a particular reason to advocate closing the loophole.

The CHAIRMAN. Thank you.

Mr. Kleczka?

Mr. KLECZKA. Thank you, Mr. Chairman.

Mr. Levy, is your major objection to the bill before us the fact that it overfunds the FSLIC problem, and can you indicate to this committee that your 2-year plan will guarantee the long-term solvency of the FSLIC fund?

Mr. LEVY. Our concern is that it provides access to a very significant amount of money, which could be accelerated by reasons of the tax reform bill, the elimination of the tax-free reorganization, so you could find the Board pushed to a case resolution level, running up against a deadline of late 1988.

Our concern there is the same concern we have in our own business: when there is too much money to be disposed of in too short a time, mistakes are made. We are talking about putting up the same amount of money, review the situation 2 years out, see what happens with the economy in these areas, and we still have our options open, the retained earnings that would be available in the bank system if it turns out the problem is not moving towards solution.

Mr. KLECZKA. With your plan, the chances are that this Congress and your association could be revisiting this problem in exactly 2 years with no resolution?

Mr. LEVY. Yes, and in the letter I referred to, this is some notion that could be the case even if the plan were passed. It is the uncertainty we have out there in terms of what is going to happen—is oil going to stay in the $16, $18 range?

There are questions we can't answer. So much has changed since a year ago. The problem has grown not because of the action of the institutions, but because the economic situation has changed in these areas.

Mr. KLECZKA. You also object to any type of exit assessments. Do you think you member associations should have the will or the power to exercise the exit fund any time they want, thus providing for a more serious problem than we have today?

Mr. LEVY. The departure should be coupled with some form of exit fee. We are not talking about the ability to depart without meeting some obligation.

Mr. KLECZKA. Where is the League with regard to the Sullivan plan, the Chinese Wall?

Mr. LEVY. I wouldn't describe it as a Chinese Wall. The Chinese Wall is either stating that savings and loans can only be insured by the FSLIC, period, and can never leave, or structuring——

Mr. KLECZKA. Was it set up for Ss and Ls originally?

Mr. LEVY. Yes.

Mr. KLECZKA. There has been a lot of talk about merging of the funds, and one member indicated if in fact we merge the funds, we would blur the distinction between commercial banks and thrifts, and you stated that that blurring has already occurred, Mr. Sullivan.

If in fact we are to look at the real world, this proposal that I am advancing would not further blur but recognize reality. Mr. Levy, under what conditions would the League support a merged system, only in lieu of this legislation, or if in fact this bill would pass, and I suspect it will, would you at that point consider support of a merged fund?

Mr. LEVY. That option is on the table. It should be discussed. We were not suggesting that, should we reach the point where we formally take on that kind of analysis, that departure is free. We assume that we are going to get into an $8 or $9 billion expenditure over the next 2 years, and during that period of time, if it would come to it, there would be an analysis of what the additional cost might be, and/or what kind of merger the funds might result.

The total size of the fund, if you put in a $15 billion fund and tell us we are going to pay a special assessment forever, you might as well keep them apart, if that is the plan.

It is an ongoing, non-ending tapping of the resources of the healthy institutions. We are trying to create a situation where the institutions can have a better chance to define what the cost might be and to have the problem relooked at.

I know we would all like to have this behind us, but considering the size of the problem, what is wrong with putting the $9 billion on the table and having another chance to look at it in 2 years?

The enormous change we have seen in the economy and the nature of the institutions in the past 2 years will compel us to come back and take a second look.

Mr. KLECZKA. Maybe after we provide for the original recap we can talk merger and get rid of that special assessment which you contend will be forever more.

The CHAIRMAN. Mr. Kennedy?

Mr. KENNEDY. If you will forgive a little rookie up here, not understanding all of these issues up here, it seems that the major point of all of this is not whether or not we are going to bail out FSLIC or what portion share the Federal Government or private industry will pay, but rather, the portion of Mrs. McGillacuttie, who initially took out that mortgage.

Mr. Levy indicates he feels the institutions could bail it out, and Mr. Sullivan——

The CHAIRMAN. Mr. Kennedy? I am having a problem hearing you.

Mr. KENNEDY. Can you hear me?

Mr. McAllister says 3,000 homeowners are going to have a very tough month in January, if any of these provisions are instituted by the Congress.

Do they in fact offer full protection for the Mrs. McGillacutties in Houston and across this country?

Mr. SULLIVAN. I don't think that any of us claim, Mr. Kennedy, that this proposal is going to provide that type of protection. It is a start.

What we are also concerned about is protecting the depositors, not only the people who own their houses, but the people who have entrusted us with their deposits. I can tell you from my own experience in Bridgeport, CT, we have three savings banks that are right around the green, and we have people who survived the Depression who split their deposits among those three because they are concerned about entrusting too much to any one of them.

Mr. KENNEDY. My question is, maybe I should ask Mr. Levy, and if you want to jump in that is fine.

I am interested in whether or not you can put in provisions in either bailout plan that would protect the homeowner who took out that mortgage; in other words, the ones you don't want to buy.

Mr. LEVY. I would be happy to ask Mr. McAllister come forward, because the focus is so local, the 3,000 foreclosures were located in Houston, one city.

Mr. KENNEDY. We got a lot of charts with a lot more than Houston.

Mr. LEVY. It involves more than just single-family residents.

Mr. MCALLISTER. I could only give you a comparison to Midland, where the FDIC took over the bank in that city. You have local economies in very precarious health, and when you have these institutions taken over by the regulators, it puts that economy into shock.

In Midland, you have a 6-month period where many businesses that dealt with that bank had new people, didn't understand their business, didn't know which people were responsible borrowers, et cetera.

When you attempt to grant some forbearance to them, it comes through with keeping those borrowers' local feel for the situation. It does have a constructive effect in these depressed economies, to keep the financial infrastructure in place.

Mr. KENNEDY. In either bailout case, it seems there should be some bottom line protection with people who have invested or are taking money out of these institutions rather than just the ones that are deemed to be healthy by some accountant.

The CHAIRMAN. Before you leave, you cited 3,000 in Houston.

Mr. MCALLISTER. I know for a fact the number for 1986 was approximately 24,000 foreclosures in Houston.

The CHAIRMAN. How many of those developments with five or six hundred townhouses, condos, high-rises, et cetera, as opposed to individual homeowners?

Mr. MCALLISTER. I don't have specific numbers.

The CHAIRMAN. These are not individual homeowners. A lot of these are developments that just didn't take off.

Mr. GONZALEZ. Will you yield to me on that point? Being that the subcommittee has been entertaining the thought of going to Houston, but the figures we had for this last year, particularly, were so acute, that they were exceeding the Pueblo, CO figures in 1983, when the steel mills closed and they were getting 100 foreclo-

sures a month, and Houston was getting 300, and these were individual homeowners, not developers or owners of large, extensive multi-housing.

The CHAIRMAN. I would be interested in getting those numbers as to how many were individual homeowners, and speculative developers, in other words.

Mr. MCALLISTER. Probably 50 to 60 percent are individual homeowners. I don't have the specific numbers.

The CHAIRMAN. Mr. Price?

Mr. PRICE. Do I understand you to say that the adoption of the Treasury plan, given its funding levels, would effectively foreclose the consideration later, the question of the merger of the funds?

Mr. LEVY. What I said is that the level of the cost to the institutions at that time would probably, if you had a passage of that plan in some form. I thought Mr. Kleczka was heading towards some form of sizable exit fee, on top of that, the cost of that plan to the individual institutions would be so great, it wouldn't matter how you resolved it unless you were able to later—maybe it could lead to an elimination or phase-out of the special assessment.

The cost of the plan is tremendous. The debt service alone will run one and a half times the regular assessment of the FSLIC.

Mr. PRICE. You acknowledge that your own earlier plan was subjected to severe criticism because of the level of resources that it would provide. You now claim that you handled those criticisms, and it was earlier mentioned it wouldn't handle immediate problems, and are you convinced that your revised plan takes account of those earlier criticisms?

Mr. LEVY. The problem with the earlier plan didn't have a body portion, so it was not front-loaded with cash. The self-help program puts $5 billion in the first 2 years, so we will virtually match the proposals that come out of the administration on the first 2 years.

At one point, they talked about a $10 billion and a $15 billion plan, but our numbers match up very well over the first 2 years. They did not under the original proposal that we had on the table last year when we didn't have a bonding feature attached to it.

The CHAIRMAN. Mr. Hubbard?

Mr. HUBBARD. Thank you very much, Mr. Chairman.

We appreciate the three of you being with us today. First, Mr. Levy, you favor a short-term recapitalization plan for FSLIC. If unsuccessful, are you supporting, as the Wall Street Journal indicated yesterday, a merger of the FSLIC into the larger Federal Deposit Insurance Corporation?

Mr. LEVY. No. The position we took is, we have a plan, our plan. The alternative to our plan, we would propose sitting down and talking about the subject of combining the funds. We would have to explore it, and we agree, that would take time.

We would hope that that discussion would take place while the $8 or $9 billion was on the table. We don't want the discussion to take place and have everything frozen in time, and not have the funds available to the FSLIC.

We want the money there, and have this 2-year period set up, and we want the cash transferred over to them to get to these different cases.

Mr. HUBBARD. Isn't your position somewhat complicating the problem for us in Congress as we try to pass legislation? Isn't it somewhat complicating it?

Mr. LEVY. I acknowledge that. Again, I guess I come back to the basic point, the uniqueness of this situation. We have talked amongst ourselves. We never saw GM and Ford come forward to provide the funds for Chrysler in 1980.

We are talking about putting our money on the table, and we are willing to put up the money for 2 years and we still have the resources of the bank system, $2.2 billion, which would be available in 2 years if more is needed.

We are saying judgmentally, can we resolve this thing and project forward based on the amount of information we have about the economy and other things today? We suggest the subject will have to be revisited.

Mr. HUBBARD. If some form of recapitalization is not passed by this Congress, is the next possible step the merger of the FSLIC and FDIC insurance funds?

Mr. LEVY. Any discussion of merging the funds is going to be very complex, and certainly not going to take place overnight. We support the injection of funds into the FSLIC.

Mr. HUBBARD. Page 13 of your testimony, and I quote you regarding the FSLIC, "In addition, there is the lingering question of whether the agency, without attracting permanent expertise for its top staff positions, can spend such enormous sums efficiently."

Would you expand on that?

Mr. LEVY. Our concern, and we have expressed this for the past year, we have gone over 1 year now with temporary directors at the FSLIC, and I think we all understand when you run an organization of that size and complexity, dealing with a problem the scope of which is unprecedented, it is very difficult to carry on with temporary management at the top.

They are not able to put change in and carry out their directives the way a permanent director would do, and we think it is imperative a permanent director be put in place.

It also gets tied in with the Bank Board and there has been a great deal of uncertainty at the Bank Board over the past year. We had a lot of departures in terms of permanent staff people, and we have a number of key positions filled by people in an acting capacity, and that is part of our concern.

We want this to be on a monitored basis, and that is one of the base reasons that we are proposing a 2-year plan.

Mr. HUBBARD. Mr. Forte, you discuss the proposed rulemaking process. You mention your opposition to amending H.R. 27 concerning this issue of direct investments.

For the record, could you now or late in writing submit a representative sampling of comments, both pro and con, about the direct investment rule? It would be helpful to us to see this sampling of views.

Mr. FORTE. I believe we could provide copies of what we understand to be all the comments on this rule, if that will be helpful, at a later date?

[The material requested by Mr. Hubbard from Mr. Forte appears on page 225.]

Mr. HUBBARD. One last question.

The CHAIRMAN. Mr. Nelson has been waiting. Mr. Nelson.

Mr. NELSON. Mr. Chairman, I would yield a few minutes to the gentleman from Kentucky.

Mr. HUBBARD. Just one question, Mr. Sullivan, Richard Pratt is quoted yesterday as saying savings and loans should worry that they will be locked into a long-term recapitalization to find out later the FSLIC still needs to be merged into the FDIC.

Is that a legitimate concern among the industry?

Mr. SULLIVAN. I assume it is. I would answer personally, Mr. Hubbard, somehow there has to be some money raised to resolve the FSLIC's immediate problems, and even if there is a merger, there has to be money somewhere to help resolve these problems.

We think that the plan that is espoused in the current legislation pending before you at least makes a start on that without involving taxpayer money. Then if the two funds have to be merged, it can be worked out on a long-term basis, and perhaps without the fire of the problem right now.

Mr. HUBBARD. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Nelson?

Mr. NELSON. Thank you, Mr. Chairman.

I wanted to, by way of review, I had heard your comments, Mr. Levy, about the possibility of the short-term recapitalization, and failing that, the question of the potential merger of FSLIC into the FDIC, could—in the way of recapitulation, could I hear from Mr. Sullivan and Mr. Forte?

Mr. SULLIVAN. At the National Council, our various committees, have not gone into that question at any length. We have discussed it as part of this overall question, but I would go back, respectfully, to the answer I gave Mr. Hubbard. The problem that we are faced with—and you and the Congress are faced with—is an immediate one that at least requires a start towards resolution. After that the question of a merger of the two funds can be looked at without the pressure of a crisis situation.

We are an FDIC-insured institution, and the rebate that was customary in the past has been eliminated. So, in effect, it costs us more. We are not assessed to the same degree as the savings and loans are, but it still has become expensive. And I gather that the FDIC itself has some concerns about some elements of its membership.

So I am not trying to duck the question, it is just so involved and so complicated that it would take intensive study.

Mr. FORTE. We, as an association, do not have a position developed at this time. And we do not at this time advocate a merger of the funds. But we are aware that this is a question that we are going to have to address, and in that light we have chosen an industry chairman for this year from a holding company that holds both—FSLIC and FDIC-insured. And we feel that the question will need to be addressed. At least industry must have positions on this question within the next year.

Mr. LEVY. I would only say that David pointed out that the FDIC premiums have increased, but in real dollars savings and loans pay 2½ times as much for their FDIC coverage as does an FSLIC institution.

The second thing is, he is FDIC-insured, as are the great bulk of the members of the National Council. Probably 70 percent—nope, 55 percent are FDIC-insured. It is perspective changes.

The CHAIRMAN. Maybe Mr. Rousselot might want to give us the exact number for the record rather than speculate.

Mr. NELSON. I yield to the gentleman from North Carolina, who has a question.

Mr. NEAL. Mr. Sullivan, I am wondering what your objection would be to Mr. Levy's plan as a first step. It seems to me we have the opportunity possibly of something that might not cost as much, might not require as long an involvement. And this committee, Congress, can always revisit any subject periodically.

What is the real problem with trying this?

Mr. SULLIVAN. As I hope I made it clear earlier, first of all, I have great respect for Mr. Levy and his intellectual ability. I just have not had time to go through that plan, nor have we at the National Council. It has been a rather recent creation. And I don't disparage his plan at all.

I would go back to our initial position, that is not intended as any criticism of his plan, but we support the administration plan as a direct response to what we see as an immediate problem that requires immediate action. This plan is a well-thought-out plan, and it does provide an immediate opportunity for the Congress to act on this question, and on this question alone.

Mr. NEAL. Would you take the time to review this?

Mr. SULLIVAN. We certainly will.

The CHAIRMAN. Mr. Parris.

Mr. PARRIS. I regret that this conflict does not allow for my Republican colleagues to be here. The exit fee is a totally new problem. It might be the reserve funds.

You believe that the thrift problems can be compartmentalized; that the thrift industry is, in fact, capable of solving its own problems.

Is your $5 billion going to get the job done?

Mr. LEVY. It is more than $5 billion.

Mr. PARRIS. I don't care what the number is.

Mr. LEVY. You have to look at the problem in its entirety.

Mr. Barnard referred to a GAO study that said, if we delay in resolving this thing, we have a carrying cost and even greater losses. It is said if the interest rates fell, the resolution costs would also fall. You have to look at where they were when they wrote the report, which was written in 1985, and they wrote that report from a perspective of 11 percent interest rates. They have already come down 2 percent.

Mr. PARRIS. Five minutes goes by very quickly. I have some things I would like to get on the record, if I might.

Isn't the fundamental problem one of what I call severability? We got, in the second quarter, 453 institutions with $110 billion worth of assets that lost $1.4 billion in that quarter alone—$470 million a month.

On a cash flow loss of 4.85 percent, when are we going to have the point where it chokes the whole system? Can we afford the delays?

Let me go on for just a moment here. The issue may very well be, it seems to me, in the Dallas district—for instance, I have great sympathy for Mr. McAllister. The Federal Home Loan Bank report of January 9 shows that the cost of funds in the Dallas region down there—8.35 percent. Mortgage yields in the Dallas district dropped from June to September by .82 basis points.

How soon do we cross the point where they can no longer continue to operate? Is the issue perhaps not how to minimize losses to the Treasury? Self-help is great; it works. But are we here to recognize the actuality of the requirement of the use of general government funds to solve this problem?

We may be witnessing a race between the Farm Credit System and the FSLIC to see who can get their hands in the Treasury first. If that is true, we got a serious problem. And if we don't address it in some effective way, we are going to really suffer the consequences as a nation, and international implications, as I indicated in my original statement.

The question is, it seems to me, have we come to the point where we should consider abandoning the dual banking system? Should we eliminate the distinctions between financial institutions and provide services to the consumer? Have we come to that point? Are we driven by the momentum of this problem?

And you submit—and this is a question, and I will stop talking—you submit that if your 2.2—if your plan doesn't work, we got the $2.2 billion and we can go to the banks and get that money and look at H.R. 27. But with the banks committing themselves under government junk bonds, is that $2.2 billion going to be there when it is committed to a $5 billion cash flow over 20 years? What is going to happen to that asset?

Mr. Levy. I will take them in order. I would start with the $2.2 billion. Remember, the Federal Home Loan Bank System has over 9 percent capital, probably, between capital and collateral that it holds; it is one of the safest institutions in the world.

I would say this. I don't think we are at the point where we have to address the question, the duality question. Seventy-seven percent of the associations are reporting absolutely record earnings, close to 1-percent yield after the payment of assessments.

I would say that your argument, though, I support you totally, and I think it compels staying within the framework of the 2-year proposal, because I am not sure how we can project out the solution in some of these economically depressed areas.

I would say that the figures you show in terms of losses, a great bulk of that is write-downs occurring. Again I have to keep coming back to it, R41c, and if you look at the institutions, their operating results aren't driving them down. They are being forced to mark this assets to market at the bottom of the cycle. We could have done that in 1981 and 1982. We didn't.

The Chairman. Mr. Parris, your time has expired.

The Chair cannot allow an ongoing debate. You asked a very lengthy question. Mr. Levy is attempting to answer it. If you want to debate, you will have to wait for your next round of questioning.

Mr. Parris. Thank you, Mr. Chairman. I think I understand the system.

The Chairman. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.
Mr. Levy, whose charts am I looking at here?
Mr. LEVY. The charts we prepared.
Mr. VENTO. Do these charts reflect the number of institutions or the dollar amount of the issue with regards to S&L or thrift problems?
Mr. LEVY. The chart in green shows the 14 States where savings and loans lost money on average, where the losses are occurring.
Mr. VENTO. Are they the number of institutions or are they the dollar loss?
Mr. LEVY. It is the aggregate loss in those States.
Mr. VENTO. The average institutions; so it is the number of institutions, not the magnitude?
Mr. LEVY. No.
Mr. VENTO. What the loss was?
I think, Mr. Chairman, that that ought to be noted, because I think that you could have States like California, where there were some very, very significant losses, but it is spread over a large number of institutions, and so therefore it wouldn't be reflected on that chart.
I think the same is probably true of the commercial bank failures; you are talking about the number of banks, are you not?
Mr. LEVY. If you take dollar losses, you would remove two States, Kansas and Nebraska. The other 12 would remain.
Mr. VENTO. But it still masks over where there may be serious problems in California, is my point, Mr. Levy, and I hope your staff understands that and the other Members of the committee. And the yellow indicates the number of institutions in terms of bank failures, is that correct?
Mr. LEVY. The 12 States with most commercial bank failures.
Mr. VENTO. So the number of banks, for instance, in Minnesota, I note my home State is on there, and we have had some small banks that have failed, but really, I think it is not significant given the overall nature of dollars in the States, and of course, the other chart, I don't believe there is any—I think the attempt here is to show there is some correlation as to where S&Ls are having problems, and of course there is some.
There is also some lack in those charts. I guess it doesn't explain everything and I guess you agree to that.
One of the questions that has come up repeatedly, of course, is the question of direct investment, which I and other Members of the committee have, and it is a legitimate concern. I guess all of you have stated that it was a legitimate concern. Some of you have supported regulatory effort to limit direct investment, in non-supportive legislative language in the recapitalization bill, as I understand it.
There is no denial that some States authorize direct investments and cause losses to the fund. I would like you to explain to me why, if Congress is going to authorize some amount or some activity to try and recapitalize the FSLIC, the insurance fund, to replace losses, we should not authorize the Bank Board to limit activities which result in losses to the fund, especially State-authorized activities.

In other words, we are in the position of providing the insurance, but having very little to say over many of the activities that are authorized for State charter institutions.

Mr. Levy?

Mr. LEVY. We certainly support limitations on direct investments. We have consistently supported that position. We have supported it most recently at the hearings that were held at the Bank Board.

I suppose we depart from you in suggesting that it be dealt with on an ongoing basis at the regulatory level, and we certainly hope that they will address this at the hearings that are going to be held at the end of the month and continue on.

Mr. VENTO. I don't want to be argumentative, but the fact of the matter is the regulatory level we are talking about three people, two of whom—at least from what I can read, I have no inside information—are not going to be there much longer and I think one or two of the other people are not going to be there. That is a very unstable, uncertain, unpredictable type of a regulatory agency to be predicting where in the hell we are going to be with direct investment.

You said that this was my position. It is one of my concerns. I don't know that it is my position.

At least at this point we have the luxury of being able to form an opinion once again on this issue. I might say I came down voting for this bill reluctantly earlier without it, but I am certain at this point that maybe we can make some progress. That is not a very predictable circumstance, is it?

Mr. LEVY. No. If I could underscore, what we are saying is we think that there has to be an ongoing limit on direct investment as part of any recapitalization proposal. Our present position is that we support an ongoing attention——

Mr. VENTO. I assume the others at the table more or less agree with what your statement is, because I see them voicing no protest. Do you think there is any correlation between the direct investment problems and the problems that S&Ls or thrifts are experiencing?

Mr. SULLIVAN. Mr. Vento, I certainly would agree that there is some correlation, but it is also a question of management. I think that if direct investment is used carefully and prudently by reasonable people running banks, that it is an important part of overall profitability.

Our position initially at the National Council was that we were against any regulation of direct reinvestment. At our most recent meeting, in studying this question, we felt that the rule at the Federal Home Loan Bank Board ought to be extended for another 2 years, simply because we did not want this particular question of recapitalization tied in with other controversial or difficult issues that had to be faced.

Personally I feel that it is a matter that should be handled by regulation rather than statutorily.

Mr. VENTO. Mr. Chairman, I guess my time has expired.

The CHAIRMAN. Mr. Levy, I want to make an observation I meant to make earlier. When you said General Motors and Ford didn't bail out Chrysler, that is a terrible comparison. Your testi-

mony was so great, and I was sorry to hear you come up with that one, because I don't know who in the League came up with that one, but it really doesn't fly, it really doesn't fly.

Mr. Dreier.

Mr. DREIER. Thank you very much, Mr. Chairman.

I would like to congratulate you, Mr. Chairman, on beginning this term with a very noncontroversial issue for the first hearing of the Banking Committee.

I would like to ask both Mr. Levy and Mr. Sullivan a question. Looking at yesterday's Wall Street Journal, you can see very clearly that one organization is in support of the administration's plan. The other is in opposition. One organization is looking at the possibility of a merger of the two funds. I guess my question is simply, why is it that the industry is so tremendously divided?

Stewart McKinney so often talks here about the necessity for us to bring about some kind of summit among all of those involved in the delivery of financial services, and only then should we consider legislation.

We are looking at one single industry here and seeing tremendous division, and I wondered if either of you would offer me some kind of explanation as to why that division exists.

Mr. LEVY. I think I tried to point out earlier, we are not mirror images of each other. Within the 3400 savings and loans, we have members that are saving bankers, that are FDIC insured; but the great, great majority of the members of the U.S. League of Savings Institutions are insured by the FSLIC. The majority of members of the National Council are insured by the FDIC, and are already over in that, so I don't know that that is even an issue that they have even gotten around to discussing. David here is also a member.

I think we are both agreed that there is need for recapitalization. Ours is a 2-year, take another look approach. There is support of the long term, but we both propose putting money into the fund.

Mr. SULLIVAN. Mr. Dreier, I would take issue with what Mr. Levy said in that while the majority, barely the majority of the members in the National Council are FDIC insured, many of the very large members of our group, such as California Federal and Anchor Savings Bank, are in fact insured by the Federal Savings and Loan Insurance Corporation.

Our task is divided equally and considers these questions very carefully, but I think the answer to your question really is that there are historical reasons for the differences.

In New England, for instance, we have had the benefit of State legislatures which have allowed us to move from the traditional mortgage and passbook business into checking accounts. We had checking accounts in Connecticut in 1973. We had installment lending powers in 1966. We have had commercial lending powers, some of which were granted after the Chairman and Mr. Garn passed their historic legislation. So there has been a historic basis, I would say, for that difference.

Mr. DREIER. There is no doubt about the fact that there is historic precedent. It is just that some of us hope to see a turn in that, and you can certainly understand that the division creates a real problem for those of us who sit on this committee, and what I

would like to ask both of you now is, what do you foresee, what is the scenario if we were to do nothing, which is what a division as created up to this point?

Mr. SULLIVAN. If we do nothing, based on everything that I have read and that we have studied, there will come a point in the very near future when the Federal Savings and Loan Insurance Company will simply have negative net worth. We are then faced with a real crisis in consumer confidence, because, if I may add, unlike legislators who are aware of the distinction, it is my opinion, based on some of our marketing study, that the average consumer does not know the difference between FSLIC and FDIC to a great degree. They know it is a bank and it is government insurance, and there have been instances where one institution gets into trouble, then everyone gets concerned.

Mr. DREIER. I am glad to know that institutions are aware of the disparity, at least, even if the consumers aren't.

I would like to yield the remainder of my time to Mr. Parris.

Mr. PARRIS. I thank my friend from California.

In response to your statement, Mr. Levy, the Home Loan Bank Board News, from the Board itself, in January shows that the FSLIC-insured firms, which is 77 percent of the firms, made $2.1 billion in the third quarter, and this is essentially a level performance, but the unprofitable firms, 23 percent, lost $2 billion, so it is essentially a wash.

Three fourths of the industry is profitable. That is our problem. It is well managed, capitalized adequately. It is doing great. One quarter at least, maybe a third, is in deep trouble. That is the problem.

Mr. LEVY. Mr. Parris, in response to that, what I am suggesting is that the losses that are being reported by the other 23 percent can't quantify it, but a significant amount of those losses are resulting from write-downs in real estate.

Mr. PARRIS. But an increasing amount of it is non-performing loans, including single-family homeowners in very depressed areas.

Mr. McAllister is in the center where the volcano is going to blow up. The question is when.

Mr. LEVY. If he were here, I think one of the things he would point out is, if we had the same treatment on those troubled assets that are afforded to commercial banks through FASB 15, through GAAP evaluation, you wouldn't have the extent of the writedowns. The banks are allowed to carry them at a lesser discount. The fact that the discounts are so deep on the appraisals that are being made under our R41c is driving that down.

Mr. PARRIS. You have got the same problem with blue sky, with good-will, in the 40-year period, and FDIC will approve it at 25. You guys are living with 40, I am told. There are lots of those kinds of distinctions.

The question is, should we maintain that? Does that make any sense?

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Gonzalez has a short statement.

Mr. GONZALEZ. Thank you, Mr. Chairman.

The statement I have is really one of a supplicant reminding and asking at the same time that we try to get some kind of a moral

commitment to housing as a primordial intention on the part of the institutions that were set up initially for the very same purpose, realize the imperative nature of the situation, but at the same time, would like to get some kind of an intended purpose fulfillment to get into housing as much as it is possible.

The CHAIRMAN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

I apologize for having to leave, but I did get confirmed as the ranking minority Member, I am pleased to say, so it is now official.

The CHAIRMAN. Welcome aboard.

Mr. WYLIE. Thank you very much.

I don't want to be repetitious with my questions, but I did want to ask you, Mr. Levy, you stated your concern, that with a $15 billion infusion into FSLIC, the Bank Board might move too rapidly in resolving some cases. I think I am stating that fairly.

You suggest a go-slow approach, citing a GAO report that by holding off in 1981-1986, the FSLIC actually saved $4.6 billion because of changes in interest rates.

Now, isn't the situation dramatically different today? Now we are dealing with an asset problem, and not really an interest spread problem. Does this suggest a go-slow approach to you?

Mr. LEVY. Mr. Barnard raised the question about the current study from the GAO, which calls for not delaying because of losses that could be taken, and I pointed out that their study was based on interest rates being at 11 percent; they are now down to 9 percent. But I don't think we are talking about going slow in that sense. We are talking about putting roughly $9 billion on the table, and allowing them to increase their level of case resolution about 75 percent above what they have been able to achieve to date.

The "going slow" that we talk about is only in the economically depressed areas, and then only with institutions that can be judged to be well managed.

Mr. WYLIE. I see. Doesn't your plan severely burden the Home Loan Banks? The 20 percent of earnings that would be dedicated to paying the costs of borrowing $5 billion in 2 years is the statutory requirement for legal reserves, and in effect under your plan for 20 years the Banks couldn't build reserves that they are required to do under the laws of safety and soundness, is that right?

Mr. LEVY. The answer to that is, under the Treasury plan they would be moving their retained earnings over in mass, upwards of $3 billion ultimately, 2.2 on hand now that would be moved out under that proposal. Yes, we call for 20 percent, only 20 percent of their earnings, whatever they earn. If they don't earn it, then we make up the difference.

Again, I state that as the Federal Home Loan Banks would grow over time, and that would be through the extension of additional credit, institutions are required to purchase stock at the time they take down additional loans, and that stock is added to the capital base, and that is why we have such a highly capitalized bank system.

Mr. WYLIE. Just suppose your alternative is not adopted. There was a rumor which was reported in the Wall Street Journal that u might not support H.R. 27, or would even actively oppose it.

Was that a fair report or a rumor, or what would be your position? What would be the position of the League?

Mr. LEVY. Our U.S. League Board of Directors, as we pointed out—and we had people from all of the 50 States—looked at a series, a priority list, and the first priority was to support the plan that we put on the table. The second is to talk about some kind of combination of the funds. Those were the two priorities we looked at.

I underscore totally and completely, we do not want to find ourselves in a situation where no funding is done. We want funds to be put into the FSLIC.

Mr. WYLIE. Thank you, Mr. Levy.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman.

I want to also congratulate the Chairman for moving forward with a good deal of speed. This is one of the first hearings that we have got in this new Congress.

And, while I have the microphone, I offer my congratulations to Mr. Wylie, who was reelected vice-chairman of this committee by one of the highest votes in our conference. I think is an idea of the regard in which he is held in our conference.

One of the gentlemen could answer this question. You recommend that the Federal Home Loan Bank Board require that generally accepted accounting principles be used for problem loans. Why do we just use generally accepted accounting principles for these loans? Why not use it for cases where it wouldn't be advantageous to use it? I mean, what is the thinking behind it?

Mr. LEVY. Let me field that. I have been waiting for that question, and it is a very good question, Mr. Roth.

The bank system requires the application of regulatory accounting principles in the evaluation of real estate. That isn't something that we asked for. That is something we were given. The essential difference between that approach and the GAAP approach is that you get much deeper discounting.

Earlier, Mr. McAllister pointed out that in Texas their discounting real estate is somewhere between 12½ and 14 percent; whereas, if you use a GAAP approach or a net realizable value, they would be discounting at the cost of funds in the overall institution, which throughout the country is 6½ to 7 percent. So it produces a much sharper write-down and gets to what Mr. Parris is talking about: these tremendous losses that are reported.

And banks are using the GAAP-type reporting on troubled assets. We are saying, let us apply that rule for troubled assets.

You are raising a broader question, I think, in terms of why this and why not GAAP in its entirety. I understand the issue completely. You know, we are both from Wisconsin. Wisconsin State-chartered institutions have never been permitted to report on anything but GAAP. We were never afforded the opportunity to go to RAP accounting, I think, and I have been a spokesman within the League pushing for the idea that we ultimately have to get back to a GAAP reporting standard. I think that is understood.

The question is, we have got to be able to do it. But I would agree with you, personally. Not speaking for the League but as an

individual, I think eventually we have to come back to GAAP reporting.

In this area, I think it is very important because the use of RAP standards rather than the GAAP standards on asset evaluation is producing the kind of write-down of assets and really exacerbating the problems in some of these very economically depressed areas.

Mr. ROTH. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Is Lake Woebegon, WI actual or not?

Mr. LEVY. That is Minnesota.

The CHAIRMAN. Is there a Lake Woebegon?

Mr. VENTO. Absolutely. There are 15,000 lakes in Minnesota. I am sure there is one up there.

The CHAIRMAN. Have you had any snow yet?

Mr. VENTO. We have had a little bit.

The CHAIRMAN. All those in Lake Woebegon were frustrated in having the snow shovels up there.

Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

That is in my district. You strike a real chord when you hit that, Mr. Chairman. I am surprised that I hadn't shared that with you before.

In looking at the issue of recapitalization, Mr. Levy, you put forth a plan that relies on using the credit of the Federal Home Loan Bank, the regional banks; is that correct? Your plan provides for $2.5 billion worth of zero coupons from that source. That would be a special assessment, then, that would go from the banks or from the financial institutions to support that; is that correct?

Mr. LEVY. Well, not quite. They would use a finance subsidiary to issue the bonds. The bonds would be issued publicly. The repayment of the bonds, the interest and principal repayment, would come from 20 percent of the bank's earnings over the 20-year period. And if the earnings of the bank system weren't high enough to meet the service, then we have to pick up—we, the savings and loans, would pick up the difference.

The bank system's earnings in 1978 have increased at an average of 14 percent a year, and this projection is done on——

Mr. VENTO. So that there would be no repayment, then, from the FSLIC fund to the bank. In other words, it would just come from the earnings of that, which is pretty strong, I guess $8 billion——

Mr. LEVY. Exactly.

Mr. VENTO. That had been rejected earlier, and as a part of that you have forbearance in other activities, I notice, but that falls far short of the initial Treasury plan of from $10 billion to $15 billion. And maybe you can just very quickly explain why that occurs that way.

I notice you have some special assessment provisions in your four-point plan. I did read it over. Forbearance—there is a four-point plan, I am sorry. And another point that I guess I didn't bring to the surface here yet.

Mr. LEVY. On a 2-year basis, our plan, including regular assessments, special assessments, borrowings, would produce $8.9 billion. The Treasury proposal would produce, actually produce, $9.9 bil-

But they would start to pay back.

Mr. VENTO. Is that more than $2.5 billion that comes out of the special zero coupon, the special agency created, or special asset corporation created?

Mr. LEVY. We are assuming there would be $2.5 billion in bonding each year.

Mr. VENTO. Oh, fine.

Mr. LEVY. For the first 2 years.

Mr. VENTO. Let me get back to another point. You know, one of the solutions here is the creation of the asset corporation in terms of an early attempt in trying to deal with the management of assets that were coming into control.

Can you comment? I have had concerns raised to me that the management of these assets is less than optimal. I mean, that is to say that they are being sold at far below what the value would be, I guess to keep things liquid. And the fact is that if we were able to hold them for a longer period of time, that there would likely be a greater return for those assets that are being managed. That is a concern that I have had raised to me from various States, certainly not from my own State at all, as a matter of fact.

Mr. LEVY. In response to that, prior to the establishment of the Federal Asset Disposition Association, I wouldn't care to comment about whether we were maximizing in all cases. I would say this: I happen to be a director of the Asset Disposition Association, and we meet regularly with that group. We review the progress. And I would say that we have brought together a highly professional group.

I just had the opportunity on the flight out here to review an asset that they had gotten involved with, and the very complex workout is such that there isn't any question in my mind—they have come up with a very creative way to maximize the return on this asset. But we are doing it continually; a very hard-nosed approach.

These are professionals. In dealing with acquirers of real estate, they know all the tricks of the game, and they are very tough negotiators. And I would say that we—we, being all people involved with maximizing the return of the FSLIC—should have some satisfaction that this system is in place.

They have about $1.8 billion under management. Including participation loans, it is close to $3 billion. But we truly have a very professional group out there. That is why I would like to see rehab——

Mr. VENTO. Do you think there is enough of that and the need for the FSLIC on the dollar flow to assure that——

Mr. LEVY. Absolutely. With each asset, a business plan is written by FADA. They write a special business plan based on their analysis of the asset and of the marketplace. And that business plan goes to the FSLIC, which will review it and sign off or request amendment. But they are out there maximizing the return.

We do not intend to be out there in some sort of firesale mode or try to liquidate assets in the shortest periods of time. We are trying to maximize the dollar return. And that, of course, isn't in the administration's plan.

I think 2 years out you are going to start seeing some real specific and hard results in terms of payback and flowback of dollar—

that are going to help the numbers that we are looking at today. We can't project forward and do it. But we will be able to look at it at that time.

Mr. VENTO. Mr. Chairman, I guess my time has expired again.

The CHAIRMAN. Does anyone have any further questions?

If not, we congratulate the witnesses not only on their performance, their answers, but their stamina.

We will be submitting some additional questions in writing and would ask you to reply to them as soon as possible. As you know, many of the Republican Members could not be here because of the conflict that occurred, and I am sure some of them will have additional questions, as will I. And we will look forward to your answering in writing those questions we have already agreed to have you give and do in writing.

We look forward to the security expert giving us analysis of the zero coupon bonds, Mr. Levy; and John Rousselot giving us numbers on the mix in the national thrifts, ABCD.

And, to my fellow New Englander, it was good spending time with you.

The committee will be in recess until tomorrow morning at 11 o'clock.

Mr. SULLIVAN. Thank you, Mr. Chairman.

[Whereupon, at 12:35 p.m., the committee adjourned, to reconvene at 11 a.m. the following day, Thursday, January 22, 1987.]

APPENDIX

STATEMENT OF

CONGRESSMAN GERALD D. KLECZKA
FOURTH DISTRICT, WISCONSIN

HOUSE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE
HEARINGS ON FSLIC RECAPITALIZATION ACT

JANUARY 21, 1987

Mr. Chairman, if the Congress approves a bailout of the Federal Savings and Loan Insurance Corporation, as seems likely, I would hope that no one is encouraged to believe that our federal deposit insurance problems have been resolved.

Real resolution of our deposit insurance crisis must include a merger of our federal deposit insurance funds.

The banks may not like the idea. And the thrifts may like the idea even less. But it is worth remembering that the lending industry strongly opposed the creation of deposit insurance by the Congress during the New Deal. Sometimes, it takes someone else to tell you what is good for your own industry.

The FSLIC bailout we consider today may work well in the best of all possible worlds. But if interest rates rise more sharply than the plan anticipates ---a leaner and meaner OPEC could contribute to this scenario--the funds raised may not be enough to cover the increase in S&L failures which would surely result. If healthy thrifts leave the FSLIC in substantial numbers to avoid extra assessments, the foundation of the bailout plan would be shaken. And there are experts who question whether the 8% annual increase in deposit growth the plan anticipates is realistic. If it is not realistic, the numbers won't add up quite so nicely.

There are several reasons why Congress should consider not simply a bailout of one deposit insurance fund but a merger of all the insurance funds.

First, marketplace changes. This is the 1980s, not the 1930s. While banks, savings and loans and credit unions had distinct, individual characteristics when their respective insurance funds were created, times have changed. Savings institutions now engage in commercial lending and all institutions compete for consumer business. Inter-industry mergers, the breakdown of geographic barriers and changes in product lines reflect the change. One large, well-staffed and flexible deposit insurance fund could anticipate changes in the financial marketplace rather than simply respond to changes as they occur.

-over-

Second, reduced risk exposure. For federal deposit insurance, commercial bank risk involves, in many instances, such factors as loan losses and the level of bank and nonbank competition. Savings institutions, on the other hand, are extremely sensitive to changes in the interest rate. The larger number and more varied type of institutions insured by a consolidated fund would broaden risk and limit exposure. Had the FDIC and FSLIC been merged in 1984, the number of financial institutions deemed "too large to fail" (institutions with assets which total 50% or more of the reserves of their respective funds) would have declined from 82 to 27, decreasing exposure and increasing stability in the deposit insurance system.

Third, coordinated regulatory policies. The General Accounting Office points out that a merged fund would would provide a single focus for evaluating the deposit insurance risk to which the federal government is exposed. Consolidation would also enable coordination of closure and liquidation procedures as well as capital and accounting requirements.

Finally, public confidence. Bailing out the FSLIC will not inspire public confidence in federal deposit insurance. If anything, it encourages comparisons of the "healthy fund" with the "sick fund." Public confidence in financial institutions was shaken profoundly in Maryland and Ohio when depositors began to differentiate between state and federally insured savings institutions. Merger of federal deposit insurance funds would preclude comparisons of the FSLIC and the FDIC at the national level.

I am now drafting legislation which would merge the federal deposit insurance funds. We may not be able to achieve a fund merger in this Congress, but I am convinced we should lay the groundwork. To do otherwise would mean opting for a quick, short-term fix at the expense of a long-term solution.

STATEMENT OF

THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

PRESENTED BY

GERALD J. LEVY

BEFORE THE

COMMITTEE ON BANKING, FINANCE & URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

January 21, 1987

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is Gerald J. Levy. I am President of Guaranty Savings and Loan Association of Milwaukee, Wisconsin and appear today to present the views of the U.S. League of Savings Institutions*.

I am immediate past chairman of the league and serve as chairman of its special task force on current issues confronting the Federal Savings and Loan Insurance Corporation, which provides federal deposit insurance coverage for approximately 3,000 of our member institutions. I am accompanied by Mr. W. W. McAllister, Jr., chief executive officer of San Antonio Savings in San Antonio, Texas, and chairman of our task force's subcommittee on regional problems. The complete text of our report has been provided with this statement.

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* The U.S. League of Savings Institutions serves the more than 3,400 member institutions which make up the $1.2 trillion savings association and savings bank businesses. U.S. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: Joe C. Morris, Chairman, Emporia, Kansas; Theo H. Pitt, Vice Chairman, Rocky Mount, North Carolina; William B. O'Connell, President, Chicago, Illinois; and Phil Gasteyer, Executive Vice President and Director of Washington Operations. U.S. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

We appreciate the priority this distinguished Committee places upon the current financial problems of the FSLIC. The situation has changed somewhat since the first formal legislative proposals to provide additional funding were made early last year. Most notably, it is clear that economic conditions in our nation vary significantly by state and local communities.

Last year it was assumed that there was a limited, one-time bulge in the FSLIC's accumulated caseload that had to be dealt with on an extraordinary basis over the next few years. But, as our reactivated Task Force on FSLIC Issues reviewed the situation, we found that the FSLIC caseload has become intertwined with the deepening economic depressions in various states which are creating major difficulties for both savings institutions and commercial banks. Well-managed institutions are being overwhelmed by local economic conditions which resemble those of the 1930s. Credit-risk problems identified a year ago are no longer confined to commercial real estate; traditional single-family home loans are now turning up in the non-performing categories in some areas. (Maps and charts appearing among the exhibits in our task force's report demonstrate the close correspondence between: states with economic problems measured by unemployment, personal income and housing starts; states experiencing commercial bank failures in 1985 and 1986; and states where FSLIC-insured savings institutions lost money, on average, in the first half of 1986.)

Thus, the capital of many institutions is being temporarily eroded by operating losses from the lack of earnings on non-performing assets. These problems are being compounded by the use of regulatory accounting provisions known as the "classification of assets" regulation adopted by the Federal Home Loan Bank Board in January, 1986. When combined with the depressed local economic environment, asset classification write-downs and strict adherence to a recently-promulgated appraisal guideline means that many sound institutions can be forced into insolvency.

The U.S. League believes that the new situation requires a new and more flexible approach to the FSLIC's problems. We propose a two-pronged "Savings Institutions Self-Help Plan".

First, adopting a flexible regulatory and supervisory policy approach already in place at the commercial banking agencies, we have asked the FHLBB to adopt a capital and non-performing loan forbearance policy for well-managed institutions located in depressed economic areas.

Second, we propose for your consideration a modified legislative plan which resembles H.R. 27, as introduced by Chairman St Germain and Representative Wylie on January 6, and as passed by the House on October 7 near the end of the last Congress. Our modifications seek to make the statutory program more manageable and flexible, encourage periodic review by the Congress as conditions evolve, and provide a program sustainable by the anticipated resources of our industry in coming years.

Our program is first and foremost a "self help" plan. It will restore the financial health of the FSLIC and well-managed institutions operating in depressed economies without turning to the taxpayer, enlarging the federal deficit, or calling for Treasury funds or guarantees. It is accomplished through the integrated regulatory, supervisory, long-term credit and depositor protection system comprised of the FHLBB, the FSLIC and the Federal Home Loan Bank System. The financial resources come entirely from regular and special assessments on FSLIC-insured institution and use of an earnings set-aside of the Federal Home Loan Bank System, which is owned by our institutions (and some FDIC-insured savings banks, for which allowance has been made). Despite the mischaracterizations of others -- including some prominent government officials who should know better -- it is entirely "self help".

FORBEARANCE FOR INSTITUTIONS IN DEPRESSED AREAS

As our League has testified in the past, the U.S. League has been concerned about "high flyers" and the exposure they have created for the FSLIC fund. We have recognized, as has the FHLBB, that restoring the health of the FSLIC also involves imposing necessary regulatory and supervisory discipline -- to contain the possibility of recurrent exposure to loss through a growing caseload of institutions in receivership.

We have been generally supportive of the FHLBB's efforts to restrain acquisition of funds through deposit brokers, to require prior supervisory approval when direct investment (in real estate, securities and service corporations) exceed 10% of assets, and to embark upon a six-year program to bring regulatory capital to 6%. We have encouraged supervisory initiatives, including the replacement of managements at high flyers, putting institutions under a Management Consignment Program with expertise borrowed from soundly-managed companies, minimizing losses on assets acquired through receivership by assigning them to the Federal Asset Disposition Association,

establishment of a separate Bank Board-level Office of Enforcement, and deployment of examination personnel to the regional banks where they may more closely monitor the problem caseload and spot potential troubled institutions. Currently, the Bank Board has a special task force working on a reorganisation plan for the FSLIC, which we commend.

While the regulatory and management initiatives just recited are helping, our Task Force recognized that regional and local economic conditions are creating operating problems even for traditional FSLIC institutions committed to thrift and home finance in their communities. These patterns, as noted, are not limited to our business, but are being experienced by commercial banks operating in depressed economies. In April, 1986 the three federal commercial banking regulators issued a policy statement for well-managed banks located in areas heavily dependent upon agricultural or energy-related economies. They established a capital forbearance program, relaxed lending restrictions based on percentages of capital, and encouraged the use of generally-accepted accounting principles (GAAP) which allow the carrying of low- or non-paying loans without writedowns which deplete capital. (The Comptroller's version of the policy statement is attached to this testimony.)

With this model, our U.S. League Task Force recommends that the FHLBB take the following actions:

#- Direct its principal supervisory agents to exercise forbearance in handling well-managed institutions in trouble due to local economic conditions; in judging whether an institution is well-managed, the PSA should determine that willful violations of laws and regulations, excessive growth or other irresponsible actions on the part of management, ownership or directors, did not contribute to an institution's distress.

#- Problem assets should be accounted for according to generally-accepted accounting principles; this involves the use of valuation standards consistent with GAAP in the carrying value of assets, appraisal discounting consistent with GAAP, and avoiding duplication with other "scheduled items" requirements (which would still apply to non-performing one-to-four family home loans).

These regulatory and supervisory steps would create a "breathing space" beneficial not only to institutions, but to the FSLIC and to local economies. As detailed in our full report there is ample precedent for Congressional and regulatory forbearance initiatives involving financial intermediaries. The enactment of the Net Worth Certificate program developed by this distinguished panel in 1982 and the regulatory accounting provisions enacted last year for the Farm

Credit System, as well as the commercial bank regulators' policy statement mentioned above, bear witness to previous prudent forbearance approaches.

Experience demonstrates that time can heal wounds -- especially where the institutions involved hold assets consisting primarily of loans secured by real estate values. For example, in the 1981-82 period, our member institutions in the so-called "rust belt" experienced the most pronounced difficulties -- but tolerance and time have proved to be the best course of action. Institutions in New York had an aggregate return on assets of -1.51 percent in 1981 and 1982, and in Illinois, of -1.0 percent. By the first half of last year, thrifts in New York had an aggregate ROA of +1.18 and those in Illinois +1.12.

From the perspective a sound overall policy approach to restoring the health of the FSLIC, forbearance is particularly important for local economies in distressed areas. If well-managed institutions are placed in receivership unnecessarily -- and if their assets are liquidated at depressed values -- economic distress will be aggravated. Competing financial institutions which are still in operation will find their portfolio values degraded and the financial infrastructure of entire communities will be threatened. The Congress and the federal regulators must make every effort to minimize such a sequence of events.

A FUNDING PROPOSAL FOR THE FSLIC

In constructing legislative authority to rebuild the FSLIC reserves, a "self help" solution must recognize the available resources of the thrift industry over the longer term as well as the size of the FSLIC's current problems and the agency's capacity to deal with them.

From the end of fiscal 1985 to the end of fiscal 1986, the FSLIC's reserves declined by $3.9 billion -- from $7.5 billion to $3.6 billion. However, as Exhibit 6 in our full report shows, the FSLIC had cash and government securities on hand of $4.6 billion at the end of September, 1986. During fiscal 1986, this figure declined by $1.1 billion. Because the FSLIC had income of $2.4 billion, this means it expended $3.5 billion during the year. During the same time period, the insurance fund showed an operating loss of $3.9 billion, but this was more than explained by $5.9 billion in accounting loss provisions.

To address the deteriorating situation, the Treasury developed the proposal essentially set forth as H.R.27. The distinguishing characteristic of this approach is the borrowing of $10 to $15 billion over the next several years (using a

financing corporation established for this purpose) to augment premium assessments and FSLIC portfolio investment income. In addition, to secure these massive borrowings, the FHLBank System would contribute $3 billion which would be used to purchase zero-coupon bonds to defease the principal of the bonds. To assure debt service, the financing corporation is given a first call on future deposit insurance premium flows.

Members of the Committee will recall that this complex funding plan attracted criticism from the Congressional Budget Office, which ruled last July that the borrowings could not be scored as government receipts for budget purposes and, as a result, spending the proceeds in resolving FSLIC problem cases would add to the federal deficit. Technical changes led to a reconsideration by CBO, which accepted the revised structure as a "close call".

As the savings institution business examined the legislative proposal of the Treasury, it too became concerned about the magnitude of the deficit spending through massive borrowings. In simple terms, our members questioned the need to "mortgage their future" by taking on the debt service of $10 to $15 billion flotations for up to 30 years. This may have some appeal to bond salesmen, but it imposed a continuing burden on an industry competing with other financial service providers while committed to a solution funded entirely by its own resources.

Our League explored various alternatives. One, known as the "pay as you go" plan, was criticized for not providing sufficient resources in the early years to handle the most immediate problems. Second, it was charged that if the FSLIC's problems proved larger than expected, there was no way in which more funds could be provided.

The Task Force which I chair sought to accommodate these criticisms when we met in December and earlier this month by fusing some elements of our "pay as you go" thoughts with a modest bonding approach. The result, which I present for your consideration, is a "Savings Institution Self-Help Plan for Funding the FSLIC".

Our approach contains four basic steps:

1. A funding corporation would be set up which would, if needed, issue zero-coupon bonds which would be repaid from the dedication for that purpose of 20 percent of net income that the Federal Home Loan Bank System currently sets aside in its so-called legal reserve (which is not available to pay dividends to thrift institution stockholders). The funding corporation could raise up to $2.5 billion in borrowing in the first year following enactment and another $2.5 billion in the second year. (The FHLBank contributions to debt service on this bonding would be adjusted for non-FSLIC shareholders.) If

Bank System earnings fall short of our projections, FSLIC-insured institutions are prepared to make up the difference.

While explained in greater detail in our full report, the following table gives the total external resources available to FSLIC under this program in comparison with the plan of H.R.27 recommended by the Treasury:

FSLIC CASH FLOW FROM EXTERNAL SOURCES UNDER INDUSTRY SELF-HELP PROGRAM AND TREASURY/BANK BOARD PLAN

Cash Flow Over:	U.S. League Savings Insts. Self-Help Program	Treasury/Bank Board Program: $10 Billion in Borrowings	Treasury/Bank Board Program: $15 Billion in Borrowings
2 Years	$ 8.9 Billion	$ 8.7 Billion	$ 9.6 Billion
5 Years	$13.8 Billion	$16.8 Billion	$21.4 Billion
10 Years	$20.0 Billion	$19.0 Billion	$21.6 Billion
20 Years	$38.7 Billion	$29.7 Billion	$28.3 Billion

Our plan provides essentially the same resources to the FSLIC over the next two years as the Treasury's version; it provides significantly more over the long term because the FSLIC would not be burdened with paying interest on two or three times as much borrowing.

In addition to these external resources, the FSLIC has investment income annually and should soon see an additional inflow of cash from the disposition work of the Federal Asset Disposition Association.

Also, it should be remembered that if the FSLIC were actually to spend more than $5 billion per year disposing of problem assets, there is a real possibility that it would be exacerbating its own problems, those of surviving savings institutions and of local economies. In addition, there is the lingering question whether the agency, without attracting permanent expertise for its top staff positions, can spend such enormous sums efficiently.

Another benefit of this approach, in comparison with the Treasury's model, is that it leaves the $2.2 billion in retained earnings of the FHLBank System intact, since it only taps only the future income stream already set aside under the provisions of the Federal Home Loan Bank Act of 1932. This feature not only reduces the threat to ongoing FHLBank System fund raising on Wall Street, but it conserves flexibility. If, for whatever reason, the authority granted by our approach proves inadequate, Congress could revisit the situation and utilize the System's retained earnings at a later date. And, savings institutions are understandably concerned about the higher debt service burden of the Treasury version.

Indeed, the League considers it appropriate that Congress review this situation periodically rather than leave it possible administratively to burden the industry and its Bank System further with huge amounts of debt.

2. We are pleased to see that H.R. 27 preserves a program for relieving FSLIC-insured institutions, over time, of the extra burden of the special 1/8 of 1% assessment which has been levied since the beginning of 1985. Under both our plan and H.R. 27, that special assessment would be phased out over six years. It is vital that savings institutions see some end to the special insurance assessment. An FSLIC-insured savings institution with the same structure as a competitor FDIC-insured bank pays at least two-and-one-half times as much for comparable federal account insurance. With the debt service burden of the Treasury/Bank Board plan, a phase-out of the special assessment is obviously less likely.

In addition to this inequity, the disparity encourages stronger savings institutions to migrate from FSLIC- to FDIC-insurance. Such a migration then depletes the overall resources of the FSLIC -- a particularly troublesome thought if FSLIC insurance also carries with it the obligation of continuing debt service for massive bonding, as under the Administration's plan.

3. Another helpful provision, already contained in H.R. 27 as Sec. 6(f), repeals unnecessary statutory language in 1982 concerning authority to tap into the historic secondary reserve of the FSLIC when the primary reserve is depleted. The presence of the language of existing law has raised concerns among certain accounting professionals that the more than $800

million in secondary reserve balances carried as assets on the industry's books should be written off -- a corresponding reduction in industry net worth -- which, of course would aggravate the FSLIC's problems through the stroke of a pen. With the "self help plan" recommended by this testimony in place, there is no need to preserve the statutory phrase added in 1982.

4. Finally, our task force believes that any FSLIC funding legislation should include, as does H.R. 27, an oversight committee with representatives from FSLIC-insured institutions to monitor and make suggestions concerning agency plans and programs for spending and caseload resolution. In addition, the FSLIC should be required to report periodically to this Committee and its Senate counterpart on its utilization of funds (as provided for in Section 6 of H.R. 27).

RELATED LEGISLATIVE ISSUES

A comprehensive legislative approach to relieve FSLIC's problems includes two additional topics -- one within the jurisdiction of your Committee and another where you could be of invaluable assistance.

The first is the familiar topic of settling the uncertainty in the Bank Holding Company Act known as the "nonbank bank loophole". The continued operation of and potential for loophole banks, operating outside the regulation of the holding company laws with privileged activities' flexibility and geographical expansion opportunities, obviously threatens the stability of existing depository institutions and the payments system. Continued exploitation of the loophole is an even greater problem in the context of conserving the resources of the FSLIC fund.

The most cost effective way to resolve FSLIC's problem caseload is to arrange supervisory mergers for troubled institutions. If potential merger partners of troubled thrifts can enter new markets or obtain a depository charter through the loophole route, there is little incentive to bid on the FSLIC's problem cases. Plugging the loophole would be of tremendous assistance to the FSLIC and our institutions which stand ready through our self-help plan to restore its reserves to full health.

We urge this distinguished Committee to revisit legislation clarifying the definition of "bank" in the Bank Holding Company Act, thus plugging the loophole, at the earliest possible opportunity.

Another important legislative issue involved with recapitalizing the FSLIC arises from sunset dates inserted in last year's Tax Reform Act. While we appreciate that such legislation falls within the jurisdiction of other Congressional Committees, your committee should appreciate the importance of the tax code provisions cited below to the FSLIC and you could be of great assistance in urging an extension of those dates.

The Economic Recovery Tax Act of 1981 included three emergency provisions in the Internal Revenue Code to assist the FSLIC. Sec. 597 made assistance payments from the FSLIC tax-exempt; Sec. 368(a)(3)(D)(ii) granted special tax-free reorganization treatment for troubled thrifts which don't meet a continuity of interest requirement after merger; and Sec.382(b)(7) sustained certain net operating loss carryovers from a troubled thrift for use by its rescuer. All three of these provisions make acquisitions of troubled thrifts more attractive to potential acquirers. However, despite the Administration's recommendation that they be continued for five years, last year's Tax Reform Act terminates them on Jan. 1, 1989 -- just two years distant.

The Chairman of the Federal Home Loan Bank Board has estimated that the savings to the FSLIC in attracting bidders for troubled thrifts is at least twice the cost in revenues foregone from these special tax code provisions. Not only would their repeal discourage supervisory mergers, but there is a very real possibility that -- as the January 1, 1989 date approaches -- the FSLIC will find itself forced to accept less favorable terms, with even greater costs to its reserves, to accomplish supervisory mergers.

We seek the good offices of this distinguished Committee in achieving a further extension of three years in these three special tax code provisions of particular importance to the FSLIC. Furthermore, given the mounting problems confronting the Federal Deposit Insurance Corporation, consideration should be given to extending their coverage to assist in the resolution of problem cases confronting that agency.

CONCLUSION

I have appreciated this opportunity to present the views of the U.S. League on these issues of overriding importance to our FSLIC-insured member institutions. We are confident that a reasoned and coordinated regulatory and supervisory approach can accommodate the challenge of sustaining our institutions devoted to thrift and homeownership in the various regions of our great nation experiencing temporary economic distress.

Furthermore, we submit for your consideration a "self-help" legislative plan to bolster the reserves of our insurance fund in a way which will be sustainable by our industry and the FHLBank System owned by our thrift business. We do not seek the appropriation of taxpayer funds to solve the FSLIC's problems.

Thank you for your attention. I look forward to your questions.

condition. The following are examples of such types of loans: For growing and storing of crops, breeding and marketing of livestock, financing fisheries, purchases of farm machinery and equipment, maintenance and operations of the farm, and discounted notes of farmers.

(2) "Oil and gas loans" include loans or extensions of credit to oil companies, petroleum refiners, and companies primarily engaged in the oil- and gas-related business, for example: Operating oil and gas field properties, contract drilling, performing exploration services on a contract basis, performing oil and gas field services, manufacturing or leasing of oil field machinery and equipment, pipeline transportation of petroleum, natural gas transmission or distribution, and investing in oil and gas royalties or leases.

(3) "Special category loan charge-offs" mean agricultural or oil and gas loans charged-off during the period from January 1, 1985 through December 31, 1987, which have been or will be reported in a special memorandum item in the bank's call report of condition in accordance with the Comptroller's capital forbearance policy.

(b) A national bank which has special category loan charge-offs resulting in a reduction in its unimpaired capital and unimpaired surplus since December 31, 1985, may substitute a lending limit calculated under this section for the general limitation provided at 12 U.S.C. 84(a)(1), up to a maximum amount of 20 percent of unimpaired capital and unimpaired surplus, until January 1, 1988.

(c) The substitute lending limit in section (b) is the lesser of the following amounts:

(1) 15 percent of unimpaired capital and unimpaired surplus on December 31, 1985; or

(2) 15 percent of the total of:

(i) The difference between the sum of special category loan charge-offs and the sum of recoveries on those charge-offs; plus

(ii) Unimpaired capital and unimpaired surplus; or

(3) 20 percent of unimpaired capital and unimpaired surplus.

Dated: April 4, 1986.

Robert L. Clarke,

Comptroller of the Currency.

[FR Doc. 86-9057 Filed 4-22-86; 8:45 am]

BILLING CODE 4810-33-M

12 CFR Part 32

[Docket No. 86-10]

National Banks; Capital Forbearance Policies

AGENCY: Office of the Comptroller of the Currency, Treasury.

ACTION: Policy Statement on Capital Forbearance.

SUMMARY: Conditions in the farm and oil and gas sectors of the economy have created increasingly severe financial pressures on farm banks and their farmer borrowers and on oil and gas banks and their oil and gas borrowers. Many farmers are facing foreclosure, and others have developed serious problems. Likewise, the volatility of energy prices has created difficulties for oil and gas borrowers.

Recognizing these problems, the Office of the Comptroller of the Currency ("OCC") is publishing this policy statement which explains its intentions with regard to supervisory policies affecting national banks adversely affected by economic conditions in the agricultural and oil and gas sectors of the economy. This statement was issued in Banking Circular No. 212, dated March 28, 1986. The statement outlines a short term capital forbearance policy designed generally to benefit agricultural and oil and gas banks having sufficient capital to absorb loan losses and reasonable prospects to replenish capital; it reiterates previous OCC statements regarding loan restructuring and accounting therefore; it describes proposed call report changes expected to be effective with the call report for the quarter ending June 30, 1986; and it announces OCC's intention to amend 12 CFR Part 32 relating to lending limits to substitute a new lending limit to offset the impact lower capital ratios would otherwise have on lending limit computations at national banks making agricultural and oil and gas loans.

EFFECTIVE DATE: March 28, 1986.

FOR FURTHER INFORMATION CONTACT: Alan Herlands, Special Assistant to the Chief National Bank Examiner, (202) 447-1646, or Zane Blackburn, Director, Bank Accounting, (202) 447-0471, 490 L'Enfant Plaza East, SW., Washington, D.C. 20219.

SUPPLEMENTARY INFORMATION:

I. Introduction

The last few years have proved to be a particularly difficult period for farm and oil and gas banks and their borrowers. Many farmers and others dependent on the agricultural economy have experienced, and continue to experience, financial difficulties. During this period, an historically large number of farm banks have failed and an even larger number have developed serious problems. Similarly, volatile energy prices have adversely impacted oil and gas borrowers and the banks that lend heavily to them.

In light of these problems, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation believe it appropriate to employ supervisory policies that will support basically sound, well-managed banks in weathering what is expected to be a difficult but transitional period. In connection with their recent testimony before Congress, the agencies released a Joint Policy Statement on March 11, 1986, outlining these policies. Although the statement refers only to agricultural banks, it has been extended to oil and gas banks by subsequent agreement among the agencies. A copy of the Joint Policy Statement is attached.

This Circular explains how the Office of the Comptroller of the Currency will implement the Joint Policy Statement. Implementation will be accomplished by encouraging banks to work with their troubled agricultural and oil and gas borrowers; by establishing a capital forbearance policy; by encouraging the use of generally accepted accounting principles which may permit loan restructurings without loss recognition; by changes to Call Reports; and by relaxing lending limits.

The Congress is considering legislation covering capital forbearance, Call Reports, and lending limits, among other matters. Modification of this Circular may be required if legislation is enacted.

Certain provisions contained in this Circular are subject to approval by the Office of Management and Budget, where they are currently under review.

II. Bank Relationships with Troubled Borrowers

Problems in the agricultural economy have directly affected the banks that provide financing for the agricultural sector. Severe financial pressures on borrowers dependent on the agricultural economy have resulted in an increase in loan delinquencies. As conditions have worsened, borrowers increasingly fear foreclosure, while bankers are increasingly concerned about supervisory actions that may result from

reduction in their banks' capital as a consequence of loan losses.

In response to this situation, the OCC has encouraged bankers to develop work-out strategies with their agricultural borrowers. In a joint statement on April 23, 1986, the Federal bank regulatory agencies reiterated their policy of encouraging banks to enter into work-out plans with agricultural borrowers who are experiencing temporary difficulties in meeting their debt service obligations. The OCC renews that encouragement now.

Although OCC examiners will point out to management the weaknesses that may be present in loans, the OCC does not require foreclosure on collateral or the acceleration of the maturity of loans. The OCC recognizes that downturns in certain sectors of the economy are expected to be transitory. Therefore, lenders may find that the most prudent policy is to restructure the loan terms rather than to take more precipitous action such as foreclosure.

The volatility in energy prices has created a similar situation between oil and gas companies and the banks that lend to them. Accordingly, the OCC also encourages banks to develop appropriate work-out strategies with their oil and gas borrowers.

III. Capital Forbearance Policy

Despite the difficult problems facing many agricultural and oil and gas banks, the OCC believes that most have sound prospects for the future. Even with the losses suffered by these banks and the likelihood that losses will continue to occur, these banks retain substantial strength. Many of them possess strong capital to asset ratios and capable management that adheres to sound lending policies.

Accordingly, the OCC has adopted, effective immediately, a capital forbearance policy which will benefit basically well-managed banks that have sufficient capital to absorb loan losses and reasonable prospects to replenish capital. Capital forbearance formally acknowledges that capital should be used during periods of unusually heavy loan losses and that capital replenishment takes time. The capital forbearance policy should provide banks greater incentives to recognize promptly losses arising in their loan portfolios, work with borrowers to restructure loans, and rebuild bank capital in an orderly manner. This capital forebearance policy is temporary and will terminate on January 1, 1989.

Under the capital forbearance policy, the OCC will not take administrative action to enforce the minimum capital requirements in 12 CFR Part 3 against a bank whose primary capital ratio declines below 5½ percent to no less than 4 percent before December 31, 1987, provided the bank meets the following qualifications and conditions.

1. The bank must meet the definition of an agricultural/oil and gas bank. An agricultural/oil and gas bank is one whose agricultural and oil and gas loans, in the aggregate, are equal to or greater than 25 percent of the bank's total loans and leases, net of unearned income. Agricultural loans are defined as loans secured by farmland and loans to finance agricultural production and other loans to farmers from Schedule C on the bank's Call Report. A list of the kinds of loans qualifying as oil and gas loans for purposes of the capital forbearance policy is attached as Exhibit A.

2. The weakened capital position of the bank must be largely the result of problems in the agricultural and/or oil and gas sectors of the economy and not due to excessive bank operating expenses, insider abuse, excessive dividends or actions taken solely for the purpose of qualifying for capital forbearance.

3. The bank must be well-managed. In reaching determinations about the quality of a bank's management, the OCC will take into account existing management's past record of performance in guiding the bank, including its timely recognition of loan losses and other weaknesses. The OCC will also consider the bank's past compliance with any agreements with, commitments to, or orders from the OCC. Further, the OCC will consider the capability of management to develop and implement an acceptable rehabilitative plan.

4. The bank must submit an acceptable plan for restoring capital by January 1, 1989 to the minimums required by 12 CFR Part 3. The plan should describe the means and schedule by which capital will be increased. This plan should also specifically address reduced dividends levels; limitations on the compensation of directors, executive officers or individuals having a controlling interest; limits on asset growth; and payments for services or products furnished by affiliated companies.[1] The plan should provide for improvement in the bank's primary capital ratio on a continuous or periodic basis from earnings, capital injections, asset shrinkage, or a combination thereof. A plan which projects no significant improvement in capital until near the end of the forbearance period will not normally be acceptable. The OCC may require modification to a bank's plan in order for the bank to receive, or to continue to receive, capital forbearance.

5. The bank must commit to file annual progress reports regarding compliance with its capital plan. Depending on an individual bank's progress, more frequent reports may be required. Moreover, any contemplated actions that would represent a material variance from the capital plan must be submitted to the OCC for review.

Banks with capital below the minimums established in 12 CFR Part 3 seeking capital forbearance must file a written request no later than December 31, 1987 with the Deputy Comptroller for the District in which the bank is located. The request must include a certification and explanation of its eligibility to participate (covering items 1 through 3 above), its plan, and its commitment to file the required reports. Capital forbearance will be considered granted unless, within 60 days of receipt of the request, the District notifies the bank that its request has been denied or that additional information or time is required. Pursuant to 12 CFR 3.8, during the period covered by this capital forbearance policy, a bank granted capital forbearance and in compliance with an acceptable capital plan will not be considered in violation of the minimum capital ratios required by 12 CFR 3.6.

Upon the written request of an agricultural/oil and gas bank and at the discretion of the OCC, the capital forbearance policy may be extended, in special circumstances, to a bank with a primary capital ratio lower than 4 percent. In addition, the OCC will consider extending its capital forbearance policy to banks which do not meet the above definition of an agricultural/oil and gas bank, but nevertheless are suffering capital declines caused by problems in the agricultural or oil and gas sectors. Capital forbearance may be extended to these banks only on a case-by-case basis upon written request and explanation submitted to the District Deputy Comptroller. In both circumstances, capital forbearance will not be considered granted until the District so notifies the bank.

The OCC reserves the right to terminate capital forbearance for banks engaged in unsafe or unsound or other objectionable practices, or if it becomes apparent to the OCC that the bank is unwilling or unable to comply with an

[1] Banks should also refer to Banking Circular No. 115, "Income Diversion Through Management and Other Fees", dated August 30, 1978, and Supplement No. 1 thereto, dated December 28, 1978.

acceptable capital plan. Capital forbearance, once granted, will not be terminated solely on the basis of subsequent changes in a bank's percentage of loans to agricultural and/or oil and gas borrowers.

Some banks are at present subject to capital requirements higher than those specified in 12 CFR Part 3 by a capital directive, an effective order issued pursuant to 12 U.S.C. 1818, or a formal agreement between a bank and the OCC. Banks which have experienced agricultural or oil and gas losses and which are subject to a capital ratio higher than the minimums set forth in 12 CFR 3.6 may request a modification from the OCC. The OCC will reconsider the higher requirement in light of the capital forbearance policy.

In addition, the OCC capital forbearance policy extends to well-managed banks whose primary capital ratios decline, as a result of problems in the agricultural or oil and gas sectors of the economy, from historic levels to levels above the 5½ percent minimum primary capital ratio. These banks do not have to apply for capital forbearance, and the OCC will not require them to take any action solely on the basis of that decline in capital. These banks will be expected to maintain adequate capital for the nature of their operations and, if appropriate, to increase their capital over time back to historic levels. In addition, these banks must recognize that asset growth should be accompanied by appropriate increases in capital.

All banks which are operating with capital levels below those which would be expected under normal economic conditions should be aware that the OCC will be unlikely to approve applications by them to acquire other banks. Similarly, the OCC will be likely to object to changes in control or acquisitions of such banks unless the transaction will result in prompt restoration of capital to appropriate levels.

The implementation of the OCC's capital forbearance policy has no effect on balance sheet or income statement items reported in Call Reports or other financial statements, nor does it allow banks to report, as assets, loans (or portions thereof) considered losses. On the contrary, the policy retains existing financial presentation rules and creates no inconsistencies with generally accepted accounting principles. The OCC believes that maintaining the integrity of financial statements is vital to assuring confidence in the banking system.

IV. Accounting for Troubled Debt Restructurings

The OCC has followed, and will continue to follow, generally accepted accounting principles with respect to loans which have been formally restructured to enable the borrower to service the debt. Statement of Financial Accounting Standards No. 15 (FAS 15), Accounting by Debtors and Creditors for Troubled Debt Restructurings, governs the accounting for such restructurings. This Standard allows a loan to continue to be carried on the bank's books without any loss recognition if the loan is formally restructured in a manner so that it is probable and estimable that the borrower can repay the loan under the new terms, and that the total future cash payments by the borrower (principal and interest combined) at least equals the loan amount on the bank's books.

Accordingly, a bank which reasonably expects a borrower's future cash payments to equal or exceed the loan amount *does not* need to recognize a loss on the restructuring. In those situations where it is expected that the future cash payments on the restructured loan will be less than the loan amount, the loss recognized is limited to the expected cash flow deficiency.

[Banking Circular 186 includes more specific details of the accounting provisions.] Bankers are encouraged to familiarize themselves with the accounting treatment described in FAS 15.

V. Call Report Changes

Two changes are being made to the Call Reports, expected to be effective with the reports for the quarter ending June 30, 1986. One is needed to monitor the capital forbearance policy and potential changes to legal lending limits for national banks; the other is designed to prevent misconceptions about certain restructured loans.

Schedule RI-B, "Charge-offs and Recoveries and Changes in Allowance and Lease Losses," will be changed for national banks to provide information relative to capital forbearance and legal lending limits. Memorandum items will be added to this schedule to identify a bank's charge-offs and recoveries of Special Category Loans on a cumulative basis since January 1, 1986. Special Category Loans are defined as (a) loans secured by farmland and loans to finance agricultural production and other loans to farmers from Schedule C of the bank's Call Report and (b) the oil and gas loans listed on Exhibit A hereto. Should the definitions change, the OCC will provide national banks with revised definitions prior to the due date for the Call Report first affected by the change.

The second set of changes involves the reporting of renegotiated "troubled" debt. The existing Schedule RC-N ("Past Due, Nonaccrual, and Renegotiated Loans and Lease Financing Receivables"), will be modified by removing the column entitled "Renegotiated troubled debt." Renegotiated loans which are performing in compliance with the modified terms will be reported in the memorandum section of Schedule RC-C under a new heading "Loans Restructured and in Compliance with Modified Terms." Renegotiated loans that become past due or are otherwise placed in nonaccrual status will be reported in Schedule RC-N in the appropriate categories.

In addition, a new memorandum item will be added to Schedule RC-N to require reporting of total renegotiated "troubled" debt included in the categories 30-89 days past due and accruing, 90 days or more past due and accruing, and nonaccrual. This memorandum item will be maintained for supervisory purposes on a confidential basis.

VI. Lending Limits

The recognition by a bank of losses on loans reduces not only its capital, but also reduces the maximum amount the bank can lend by law to any single borrower. Lending limits are an important ingredient in protecting the safety and soundness of banks by requiring diversification of credit risks. Many banks have established internal controls limiting the size of loans to any single borrower to an amount less than the legal lending limit. In those banks that do make loans at the legal lending limit, such loans are generally small in number. However, the declines in capital attributable to the problems in the oil and gas and agricultural sectors of the economy may cause some banks to be unable to serve the normal credit needs of a greater number of their creditworthy customers. In order to reduce the impact of these loan losses on a bank's ability to meet the legitimate credit needs of its financially sound customers, the OCC believes it necessary and appropriate to relax lending limits during the period in which the capital forbearance policy is in effect.

The Federal statute governing national bank lending limits is 12 U.S.C. 84. The OCC has issued implementing regulations at 12 CFR Part 32. In general, national banks are subject to a *General* limitation of 15 percent of total capital

(i.e. unimpaired capital and unimpaired surplus), and may lend an additional 10 percent of total capital to the same borrower fully secured by readily marketable collateral. There are also a number of exceptions for specified types of loans. Under the statute, the OCC has the authority to establish limits other than those specified.

Under that authority, the OCC contemplates adopting as soon as possible a temporary amendment to 12 CFR Part 32 to be consistent with the purposes of the capital forbearance policy. It is anticipated at present that the amendment would substitute an increased general lending limit for national banks to offset the decline in capital resulting from losses attributable to problems in the agricultural and oil and gas sectors of the economy. As an offset, the new general lending limit would not increase any bank's lending limit above what it would have been had it not experienced losses attributable to these troubled economic sectors. The OCC also contemplates including in the amendment a maximum general lending limit of 20 percent to preserve the benefits of risk diversification. The change would cover losses occurring after January 1, 1986 and no later than December 31, 1987, but the effect of these losses on lending limits would continue until January 1, 1988.

The change would allow banks, whose capital declines by no more than 20 percent as a result of losses attributable to agricultural and oil and gas loans, a general lending limit of 15 percent of their capital as of December 31, 1985. For example, a bank with a 10 percent capital ratio, whose capital ratio at December 31, 1985 subsequently declines to 8 percent as a result of losses attributable to the agricultural or oil and gas sectors, would have no reduction in its general lending limit. For banks whose capital ratios are even more dramatically reduced, the effect of the new provision would be a general lending limit of as much as 20% of their reduced capital. The new general lending limit rule would expire simultaneously with the capital forbearance policy on January 1, 1988. Comment will be solicited on the temporary amendment.

Exhibit B hereto is a worksheet which would enable national banks to compute their general lending limits under the new rule. The Comptroller will send appropriate material to national banks relating to the formal adoption of the change to 12 CFR Part 32. *The new lending limit will not be effective until formal adoption of the rule.*

Dated: March 28, 1986.

Robert L. Clarke,

Comptroller of the Currency.

Exhibit A—Definitions of Oil and Gas Loans

The types of loans listed below, regardless of purpose will be considered oil and gas loans for the purposes of qualifying for capital forebearance. Wherever "company" is referenced, the caption also assumes "individuals". SIC stands for Standard Industry Codes. See following pages for definitions.

A. Loans to the major integrated oil companies;

B. Loans to companies engaged in operating oil and gas field properties (SIC 1311) (production);

C. Loans to companies primarily engaged in contract drilling (SIC 1381);

D. Loans to companies primarily engaged in performing exploration services on a contract basis (SIC 1382);

E. Loans to companies primarily engaged in performing oil and gas field services (SIC 1389);

F. Loans to petroleum refiners (SIC 2911);

G. Loans to manufacturers and lessors of oil field machinery and equipment (SIC 3533, 7394);

H. Loans to companies primarily engaged in pipeline transportation of petroleum (SIC 4612, 4613);

I. Loans to companies primarily engaged in natural gas transmission or distribution (SIC 4922, 4923, 4924);

J. Loans to companies primarily engaged in investing in oil and gas royalties or leases (SIC 6792);

K. Loans to others engaged in oil and gas related activities.

Major Integrated Oil Companies

International Companies

British Petroleum Co.
Chevron Corp.
Exxon Corp.
Gulf Oil Corp.
Mobil Corp.
Royal Dutch/Shell Group
  Royal Dutch Petroleum Co.
  Shell Oil Co.
  Shell Canada Ltd.
  Shell Transport & Trading Co.
Texaco, Inc.

Domestic Companies

Amerada-Hess
Ashland Oil Co.
Atlantic Richfield Co.
Kerr McGee Corp.
Occidental Petroleum Co.
Pennzoil
Phillips Petroleum Co.
Standard Oil Co. of California
Standard Oil Co. (Indiana)
Standard Oil Co. (Ohio)
Sun Company, Inc.
Tenneco Co.
Unocal

SIC CODES

SIC 1311—Crude Petroleum and Natural Gas

Establishments primarily engaged in operating oil and gas field properties. Such activities include exploration for crude petroleum and natural gas; drilling, completing, and equipping wells; operation of separators, emulsion breakers, desilting equipment; and all other activities in the preparation of oil and gas up to the point of shipment from the producing property. Also includes the production of oil through the mining and extraction of oil from oil shale and oil sands.

SIC 1381—Drilling Oil and Gas Wells

Establishments primarily engaged in drilling wells for oil or gas field operations for others on a contract, fee, or similar basis. Includes contractors that specialize in "spudding in," "drilling in," redrilling, and directional drilling.

SIC 1382—Oil and Gas Field Exploration Services

Establishments primarily engaged in performing geophysical, geological, and other exploration services for oil and gas on a contract, fee or similar basis.

SIC 1389—Oil and Gas Field Services

Establishments primarily engaged in performing oil and gas field services, for others on a contract, fee, or similar basis, such as excavating slush pits and cellars; grading, and building of foundations at well locations; well surveying; running, cutting, and pulling casings, tubes, and rods; cementing wells; shooting wells; perforating well casing; acidizing and chemically treating wells; and cleaning out, bailing, and swabbing wells.

SIC 2911—Petroleum Refining

Establishments primarily engaged in producing gasoline, kerosene, distillate fuel oils, residual fuel oils, lubricants and other products from crude petroleum and its fractionation products, through straight distillation of crude oil, redistillation of unfinished petroleum derivatives, cracking or other processes.

SIC 3533—Oil Field Machinery and Equipment

Establishments primarily engaged in manufacturing machinery and equipment for use in oil and gas fields.

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SIC 7394—Equipment Rental and Leasing Services

—Oil field equipment rental
—Oil well drilling equipment rental: Machinery, drilling bits, etc.

SIC 4612—Crude Petroleum Pipe Lines

Establishments primarily engaged in the pipe line transportation of crude petroleum.

SIC 4613—Refined Petroleum Pipe Lines

Establishments primarily engaged in the pipe line transportation of refined products of petroleum, such as gasoline and fuel oil.

SIC 4922—Natural Gas Transmission

Establishments engaged in the transmission and/or storage of natural gas for sale.

SIC 4923—Natural Gas Transmission and Distribution

Establishments engaged in both the transmission and distribution of natural gas for sale.

SIC 4924—Natural Gas Distribution

Establishments engaged in the distribution of natural gas for sale.

SIC 6792—Oil Royalty Traders

Establishments primarily engaged in investing in oil and gas royalties or leases, or fractional interest therein.

SIC 1321—Natural Gas Liquids Production

Establishments primarily engaged in producing liquid hydrocarbons from oil and gas field gases.

SIC 1623—Pipe Line Construction

—Distribution lines (oil and gas field construction)
—Pipe laying
—Pipe line construction
—Pipe line wrapping
—Pumping station construction

SIC 1629—Heavy Construction

—Oil refinery construction
—Petroleum refinery construction

SIC 3494—Valves and Pipe Fittings

SIC 3498—Fabricated Pipe and Fabricated Pipe Fittings

SIC 3559—Special Industry Machinery

—Petroleum refinery equipment

SIC 4226—Special Warehousing and Storage

—Oil and gasoline storage caverns (for hire)
—Petroleum and chemical bulk stations and terminals for hire

SIC 4925—Mixed, Manufactured or Liquefied Petroleum Gas Production and/or Distribution

Establishments engaged in the manufacture and/or distribution of gas for sale, including mixtures of manufactured with natural gas.

SIC 5084—Industrial Machinery and Equipment

—Derricks (Wholesale)
—Drilling bits (Wholesale)
—Oil Refining machinery, equipment, and supplies (Wholesale)
—Oil well machinery, equipment; and supplies (Wholesale)
—Oil well supply houses (Wholesale)

SIC 5171—Petroleum Bulk Stations and Terminals

Establishments primarily engaged in wholesaling petroleum products, including liquefied petroleum gas, from bulk liquid storage facilities.

SIC 5172—Petroleum and Petroleum Products Wholesalers

Establishments primarily engaged in wholesaling petroleum and products. Included are packaged and bottled petroleum products distribution, truck jobbers, and other marketing petroleum and products at wholesale.

SIC 6211—Security Brokers, Dealers, and Flotation Companies

—Oil and gas lease brokers
—Dealers in oil royalties

SIC 8911—Engineering, Architectural, and Surveying Services

—Petroleum Engineering

Others

Establishments and individuals engaged primarily in oil and gas related activities. Examples of such loans would be mortgages and personnel loans to individuals whose sole source of repayment is from the profits of an oil or gas company or employment by an oil or gas company.

Exhibit B—General Lending Limitation Calculations

[For use until January 1, 1988]

Calculation date ————————

1. Total capital on December 31, 1986.	——
2. 15% of the amount on Line 1	——
3. Total capital on calculation date...	——
4. 15% of the amount on Line 3	——

IF THE AMOUNT ON LINE 4 EQUALS OR EXCEEDS THE AMOUNT ON LINE 2, STOP HERE. THE BANK'S CURRENT GENERAL LENDING LIMITATION IS THE AMOUNT ON LINE 4.

5. Sum of Special Category Loan Charge-offs since December 31, 1986 (but only through December 31, 1987).	——
6. Sum of all recoveries since December 31, 1986 on all loans included in Line 5.	——
7. Amount on Line 5 minus amount on Line 6.	——
8. Amount on Line 3 plus amount on Line 7.	——
9. 15% of the amount on Line 8	——
10. 25% of the amount on Line 3	——
11. Lesser of the amounts on Line 9 and Line 10.	——
12. Lesser of the amounts on Line 2 and Line 11.	——

THE BANK'S CURRENT GENERAL LENDING LIMITATION IS THE AMOUNT ON LINE 12.

[FR Doc. 86-[illegible] Filed 4-22-86; 8:45 am]

BILLING CODE 4810-33-M

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 71

[Airspace Docket No. 86-AGL-4]

Establishment of Transition Area; Paxton, IL

AGENCY: Federal Aviation Administration (FAA), DOT

ACTION: Final rule.

SUMMARY: The nature of this action is to establish the Paxton, Illinois transition area to accommodate a new VOR Runway 18 instrument approach procedure to Paxton Airport.

The intended effect of this action is to ensure segregation of the aircraft using approach procedures in instrument conditions from other aircraft operating under visual weather conditions in controlled airspace.

EFFECTIVE DATE: 0901 U.T.C., July 3, 1986.

FOR FURTHER INFORMATION CONTACT: Edward R. Heaps, Air Traffic Division, Airspace Branch, AGL-520, Federal Aviation Administration, 2300 East Devon Avenue, Des Plaines, Illinois 60018, telephone (312) 694-7360

Statement of

David J. Sullivan, Jr.
on behalf of the
National Council of Savings Institutions

before the

Committee on Banking, Finance and Urban Affairs
United States House of Representatives

on

H.R. 27
FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
RECAPITALIZATION ACT OF 1987

Room 2128 Rayburn House Office Building
January 21, 1987

Mr. Chairman and Members of the Committee, my name is David J. Sullivan, Jr., President and Chief Executive Officer of the Mechanics and Farmers Savings Bank, F.S.B., Bridgeport, Connecticut. I am appearing today in my capacity as Treasurer of the National Council of Savings Institutions, a trade association representing approximately 600 savings banks and savings and loan associations with total assets of $450 billion. Our members include both FDIC and FSLIC-insured institutions.

Mechanics and Farmers Savings Bank is an FDIC-insured institution and a member of the Federal Home Loan Bank of Boston. I currently serve on the Board of Directors of the Boston FHLB.

We are very pleased to accept your invitation to testify at today's hearings, and we commend your initiative in moving quickly to bring the subject of FSLIC recapitalization before the Banking Committee.

STATE OF THE INDUSTRY

I would like to begin by briefly reviewing the current state of the industry in order to establish the economic and financial framework against which our member institutions evaluate FSLIC recapitalization. Ninety-eight percent of the Council members are operating profitably; and for most of these institutions, their earnings are at a record high. This is quite contrary to the erroneous impression created by the over-publicized problems of the FSLIC and the relatively small number of unprofitable institutions that the state of the thrift industry is one of declining economic performance. In fact, Mr. Chairman, nothing could be further from the case.

The Council's research department estimates that 1986 will be another record profit year for FDIC-insured savings banks. In fact, as of

the third quarter of 1986, only one FIDC-insured savings bank had not returned to profitability.

Reflecting both the favorable interest rate environment that I have previously mentioned, as well as the portfolio restructuring accomplished by many institutions, the surplus accounts of FDIC-insured savings banks rose at an annualized rate of 96 basis points on average assets in the third quarter. As a result, capital margins have increased dramatically in the last year, and we expect 1987 to indicate further positive results along this trend line.

Annualized Net Change in Savings Bank Surplus as Percentage of Average Assets, Quarterly

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Calendar Year
1986	.48%	.52%	.96%		
1985	.30	.40	.35	.55%	.40%
1984	*	-.12	.16	.29	.08
1983	-.04	.32	.17	.15	.15
1982	-.92	-.88	-.64	-.35	-.86
1981	-.48	-.76	-1.08	-1.20	-.86
1980	.28	.40	-.32	.04	-.10
1979	.68	.56	.44	.24	.47
1978	.60	.72	.56	.40	.57
1977	.60	.60	.56	.44	.55
1976	.40	.44	.56	.36	.44

* = Less than .005 percent.

Note: Data refer to net changes in surplus, undivided profits, reserves from retained earnings and exclude debentures, capital infusions from FDIC, net worth certificates and net stock issues.

Average capital at FDIC-insured savings banks was 7.3 percent as measured by Generally Accepted Accounting Princpals (GAAP). As indicated by the following chart, savings bank capital positions have recovered fully and have now returned to the historic levels that prevailed prior to the extreme financial stress of the early 1980s.

Ratio of General Reserve Accounts to Assets of Savings Banks 1975-1986

1986p	7.32%
1985	5.92
1984	5.12
1983	5.36
1982	5.30
1981	5.68
1980	6.63
1979	7.05
1978	6.90
1977	6.77
1976	6.71
1975	6.96

p = preliminary, based on October, 1986 data

On the savings and loan side, the economic picture shows similar earnings and capital improvement, as well as the traditional, more positive deposit growth than is the case with savings banks which are predominantly located in the Mid-Atlantic and New England regions of the country. On the negative side, there continue to be close to 400 FSLIC-insured institutions which have not been able to take advantage of the lower interest rate environment due primarily to problems relating to asset quality. As has been the case in commercial banking, these institutions are concentrated in those areas of the country which have been impacted adversely by the price decline in oil and agricultural products.

Notwithstanding these regionalized problems, we estimate that 1986 will be another year of strong profits for savings and loan associations and that the industry will continue making major strides in rebuilding its net worth. Retained earnings, as indicated below, have declined somewhat from a year earlier, reflecting a considerable writedown of foreclosed real estate, particularly among those institutions in the so-called Management Consignment Program.

Retained Earnings as Percentage of Total Assets of Savings and Loans 1975-1986

Year	Percent
1986p	0.21%
1985	0.27
1984	0.15
1983	0.27
1982	-0.64
1981	-0.73
1980	0.13
1979	0.67
1978	0.81
1977	0.77
1976	0.63
1975	0.47

p = preliminary

Just recently, the FHLBB increased regulatory capital requirements to 6 percent for FSLIC-insured institutions with a transition period geared to average industry earnings. Based on realistic interest rate predictions, we see no reason this target cannot be met by most institutions before the end of this decade.

FSLIC RECAPITALIZATION

While FSLIC-insured institutions, in the aggregate, are thriving, the anomaly is that the health of the FSLIC is indisputably going from bad

to worse. Based on estimates made by the Government Accounting Office and private studies, non-committed reserves are less than $2 billion against total insured deposits approaching $1 trillion. Near term (12 months) resolution costs are projected to be between $5-$6 billion, and anticipated income from regular assessments, special assessments, and portfolio earnings are estimated to be $2.5 billion for 1987. The financial picture is obviously more complex than this, given the existence of so-called secondary reserves which are counted as assets by both the FSLIC and the insured institutions. Another complication is the explosive growth of FSLIC guaranteed advances which currently stand at approximately $3 billion. The bottom line is that these numbers simply do not add up to a viable insurance alternative unless substantial new funds are injected within the next six to twelve months.

This being the case, the basic public policy question confronting the Congress is whether the shortfall in current FSLIC reserves should be made up by the healthy segment of the industry or the government itself. Good arguments exist on both sides of this question. Certainly the industry at large has benefitted over the years from a separate insurance fund. On the other hand, forcing the industry's healthy members to pay the liquidation costs of its weakest members is to assign responsibility to institutions for circumstances over which they have no control.

The National Council was the first to suggest a solution somewhere in between--namely, a private/public partnership that would utilize the resources of the Federal Home Loan Banks as the lever for generating new

funds for FSLIC. In testimony before the Congress two years ago, we outlined the following approach to FSLIC recapitalization:

> The most obvious and most readily implemented is for the FSLIC to borrow what it needs by establishing a standby line of credit with the Federal Home Loan Banks. The banks currently hold capital amounting to over $8 billion. They may be better able to carry the short term burden than are the individual thrift institutions. We recognize that the Federal Home Loan Banks are owned by the thrifts and that this idea would still reflect a cost to the industry; but, this may be an easier way to bear the burden.*

Unfortunately, this suggestion was not favorably received by either the FHLBB or the regional banks when we initially made it in early 1985. Instead, energy was expended on designing the Management Consignment Program and creating the Federal Asset Disposition Association. This is not to suggest these programs have not been of some assistance in easing FSLIC's problems, but neither are they a substitute for "real money" solutions.

Responding to a Congressional directive, the Treasury Department began in 1986 to develop a borrowing program premised on a capital contribution of up to $3 billion from the Federal Home Loan Banks. These funds would be used to establish a Financing Corporation which would support as much as $15 billion of capital market borrowings. Under the terms of the plan, these borrowings would then provide equity funds to FSLIC for use in disposing of failed institutions. In response to

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* Hrgs. on Federal Regulation of Direct Investments by Savings and Loans and Banks; and Condition of the Federal Deposit Insurance Funds before the Subc. on Commerce, Consumer and Monetary Affairs of the H. Comm. on Gov. Operations, February 25, 1985, p. 169.

objections by the Congressional Budget Office, the original plan was modified in order to avoid any budgetary impact by empowering the Financing Corporation to assess FSLIC-insured institutions to service its capital market debt, while FSLIC's assessment would be correspondingly reduced.

In June, 1986, the National Council's Task Force studying this issue recommended support for the Treasury/FHLBB plan under the following conditions.

1. The legislation should provide that the 1/8 of one percent special assessment be phased out in equal increments in 5 years with FSLIC retention of its existing statutory authority to impose an assessment in future years if needed.

2. Market borrowings under the proposed program should be spread out over a period of years, so that funds are raised only as needed.

3. FSLIC should be directed to prepare a quarterly case resolution planning budget indicating prospective uses of funds to deal with problem institutions. This budget should be submitted for review to a special industry advisory committee composed of thrift institution executives.

4. Special consideration should be given to those bank districts where FDIC-insured thrifts own substantial amounts of FHLB stock.

5. There should be no barriers to the ability of depository institutions to shift between FDIC and FSLIC insurance.

6. FHLBB and FSLIC staff personnel should be removed from the restrictions imposed by the Office of Personnel Management in order to attract and retain high quality examiners.

Both the Treasury and the Congress were generally responsive to these suggestions when the bill was being debated last year. Amendments approved by both the House and Senate authorized a review board to meet

quarterly for the purpose of advising on budgetary planning and prospective expenditure of the additional funds raised. Language was also included in the bill providing for a phase-out of the special assessment. Finally, the capital contributions of the Boston and New York district banks, where most of the FDIC-insured thrifts are located, were appropriately adjusted.

On January 12, 1987, we reconvened our Task Force and, after considerable debate and examination of a number of different options, it was agreed that the Council should continue to support the Treasury/FHLBB plan. In fact, Mr. Chairman, because conditions at the FSLIC have materially worsened during the intervening months, we are now prepared to support immediate enactment of a FSLIC recapitalization measure regardless of whether our recommendations are addressed now or deferred for subsequent consideration.

We take this position because the indisputable fact is that in the absence of any new infusion of capital, FSLIC will be unable to deal with its current, let alone future, case resolutions. The anticipated cost of this effort is known to be at least $10 billion in 1987, with the eventual figure rising in fairly short order to $25 billion. This is not an amount which can be met through current and special assessments and earnings on reserves. Nor is it an amount which can be handled in a business-as-usual method. The clear message we would like to leave with the Committee today is that resolution costs have already been stretched out far too long and in too many cases.

The real risk of inaction is that the healthy section of the thrift industry which I have described will be irreparably injured by the

inability of the FSLIC to handle its current problems. We estimate, for example, that the costs of generating deposits as an FSLIC-insured thrift is approximately 50 basis points higher than the cost of raising liabilities for a similarly-situated FDIC-insured bank. This disparity is largely the result of the perceived weakness of the FSLIC fund.

Now, of course, the Congress has its own priorities, as do the regulatory agencies, the Administration, and other interest groups. Should the FSLIC recapitalization as passed last year and reintroduced this year by you and Mr. Wylie as H.R. 27 be unable to pass as an emergency measure, then, time permitting, we would likewise advocate some modifications. First on our list would be that some additional consideration given to the question of how the Bank Board will administer this up-front infusion of more than $15 billion in cash. The advisory board of industry representatives called for in the 1986 FSLIC recapitalization plan needs to be strengthened considerably in terms of both its composition and its mission.

Given the administrative burdens already facing the FHLBB as the chartering agency of federal thrifts, regulator of S&L holding companies and operator of the Federal Home Loan Mortgage Corporation, we suggest that perhaps the time has come to restructure the FSLIC more along the lines of the independent FDIC. For example, operating control over the monies raised by the Financing Corporation could be vested in a public/private board composed of diverse government officials. The FDIC, for example, has an employee of the Treasury, namely the Comptroller of the Currency, serving on its Board, and we suggest that a representative of the Federal

Reserve Board might also be a source of additional expertise for this reconstituted panel.

Another point which received considerable attention last year relates to the ability of institutions to convert from FSLIC to FDIC insurance—the so-called "Berlin Wall" issue. This issue first surfaced in May, 1986, when, at the request of the Congress, the Treasury submitted language prohibiting FDIC-insured institutions from membership in the FHLBB system. This amendment seemed to overlook the previously discussed fact that in the New York and Boston Federal Home Loan Bank districts, FDIC-insured thrifts constitute the majority shareholders of the Federal Home Loan Bank stock. Fortunately, this language was subsequently deleted from the FSLIC recapitalization bill, and other more onerous "Berlin Wall" amendments that surfaced during House consideration were likewise not adopted.

The National Council remains strongly of the view that current FSLIC problems in no way justify the reversal of 50 years of statutory authority which has permitted FDIC-insured thrifts to become members of the FHLBB; nor does it warrant the imposition of a prohibition or temporary moratorium on the ability of institutions to move from FSLIC to FDIC and vice versa. On December 19, 1986, this issue was the subject of a court action in Florida, in which the District Court voided an "interpretive ruling" adopted by the FHLBB on October 7, 1986, stipulating that institutions must obtain Board approval before leaving the FSLIC system. The Court also took this occasion to comment on the recent practice of the Board to impose "exit penalties" equal to the present value of 10 years of insurance premiums on those institutions converting to FDIC insurance. The Court termed these exit premiums "extortion."

In tha view of the Council, which participated as amicus curia in the Florida case, the clear state of the law on this point is that the Board is without statutory authority to reverse its long standing policy of permitting institutions to switch from FSLIC to FDIC insurance without paying any exit fee whatsoever. The National Housing Act does mention two years of continued pramiums when an institution terminates FSLIC coverage, but this provision has never been interpreted to cover the replacement of FSLIC insurance with FDIC coverage.

We have likewise had a task force of affected institutions working on this issue and, notwithatanding the Board's long-standing administrative policy that no exit fee pertains when an institution remains within the federal deposit insurance system, we believe that given the current strains on the FSLIC fund, some reasonable exit fee is appropriate. At our Board of Directors meeting held on December 9, 1986, the National Council approved the position that institutions should ba allowed to leave the FSLIC provided they pay an exit penalty equal to two years of regular premiums plus two years of special assessments. We further suggest that the authority to impose the two years premium should terminate within five years as per the phase-out period for the special assessment included in H.R. 27.

Adoption of this compromise would provide institutions in the marketplace with some degree of certainty both as to the cost and the timing of action on applications involving FSLIC to FDIC conversions. Especially in those states which are part of regional pacts or otherwise

permit interstate banking, merger activity is proceeding apace and many of these transactions involve inter-industry acquisitions. Without the amendment we are suggesting, the industry will be confronted with the delays and costs of continued legal appeals, and the FHLBB will be deprived of any exit fees as was the case with two major transactions completed within the last two months.**

As a final comment on the new provision of H.R. 27 that would subject the Federal Asset Disposition Association to GAO review, I would state that the National Council supports this change. Although FADA has not taken title to any property under its present business operations, public scrutiny of this type would benefit all the parties concerned.

CONCLUSION

In closing, I would like to thank you again for the opportunity to testify. Our basic message is that the declining state of FSLIC finances constitutes a problem of major proportions requiring immediate action. We urge the Committee in the strongest possible terms to support the Treasury/FHLBB plan and bring this matter before the full House for expeditious consideration. We hope that Senate concurrence will follow shortly thereafter.

I would be very pleased to answer any questions which Committee members may have at this time.

** Westchester Financial Corporation acquired by Marine Midland Bank of New York, and United First Federal Savings and Loan Association acquired by Barnett Banks of Florida.

TESTIMONY OF THE

ASSOCIATION OF THRIFT HOLDING COMPANIES

BEFORE THE

HOUSE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

Mr. Chairman and Members of the Committee:

Thank you for asking the Association of Thrift Holding Companies to provide you with our perspective on H.R. 27.

I am Patrick A. Forte. As president of the Association of Thrift Holding Companies, I represent an organization solely devoted to the concerns of thrift holding companies. Our association, in fact, is the only organization representing thrift holding companies. Our most recent count of thrift holding companies indicates there are approximately 270 thrift holding companies and together they hold more than 280 insured thrift subsidiaries in 44 states which, in turn, hold more than $380 billion in insured deposits.

Our members are keenly aware of the need to improve the financial position of the FSLIC. With an estimated primary reserve of $1.9 billion, FSLIC is confronted with potential payouts of possibly $25 billion. This disparity threatens not only the thrift industry and the consumers who rely on it, but the nation's economic health.

This problem must be dealt with as soon as possible. A major recapitalization plan with wide support must be agreed on so the thrift industry can regain the public confidence it desperately needs.

FSLIC funds have become virtually depleted over a period of years. Working with dangerously limited reserves, harried regulators have struggled to salvage troubled thrifts or liquidate them with minimum impact on local communities. It is a situation that cannot be expected to long continue. Delays in dealing with the problem will only increase the ultimate costs to the insurance fund and clearly present the possibility of a taxpayer assisted plan.

At the same time, I want to emphasize to this committee that the problem we are facing has not been caused by mismanagement within the thrift industry. In only a handful of well publicized cases has capital depletion derived from management malfeasance.

The primary drain on FSLIC's resources can be attributed to the inability of the thrift industry to build or to raise capital because of corporate structure, dislocations in the economies of certain regional areas, inadequate management, and the lack of regulatory foresight.

As to regulatory foresight, for example, in the last year the Bank Board has created havoc within the thrift industry by significantly changing the rules for evaluating industry assets. The combination of its new classification of assets rule and its R-41c memorandum governing the appraisal of assets has severely impaired thrift industry operations. The classification of assets regulation allows Bank Board examiners, functioning with virtually no objective Board guidance, to write down assets at their own discretion. The R-41c memorandum, moreover, will

require immediate and substantial writedowns, often producing values far below those that would result from applying generally accepted accounting principles. Put another way, by writing down industry net worth to a degree not required by generally accepted accounting principles, the Board has made even more urgent the need to pass a recapitalization bill.

Without a major effort to improve the means by which thrift institutions can be themselves capitalized, the ongoing cost of deposit insurance will become an increasing burden on those thrifts which are now well capitalized. In other words, the strong thrifts will indirectly pay an increasing subsidy to the weak thrifts, which will in turn weaken thrift earnings and hamper the building of capital through retained earnings.

This is the principal reason members of our association believe FSLIC recapitalization addresses only a small, albeit pressing, aspect of the larger problem of undercapitalized thrift institutions. Regardless of its financial strength, FSLIC alone cannot solve thet problem.

Further, it should be noted that in addition to the FSLIC, thrift depositors, and taxpayers, there are a great number of individual investors who have a great stake in this industry. Over the past four years, investors have provided $14.2 billion to thrifts. That is, in the process of conversions, during 1983, there was an investment of $3.5 billion; 1984, $800 million; 1985, $2 billion; and 1986, $4.6 billion -- a total of $10.9 billion of additional equity through stock purchases. In

addition, during the same period, investors have provided $2.3 billion in the form of subordinated debt -- another form of capital. Without this infusion of capital, the distress of the FSLIC and the industry would have been further exacerbated. Therefore, the interest of these public investors must also be considered by the Congress in insuring the viability of the FSLIC.

On behalf of the members of our association, I ask this committee to look beyond the immediate needs of the FSLIC and to consider at the earliest opportunity measures that will set about improvements to statutory and regulatory programs that will have the effect of encouraging further private capitalization of the thrift industry.

As an organization of thrift holding companies, some of the concerns which we have that have ramifications that go beyond the affected holding companies include:

-- The limitations now imposed on transactions with affiliates. One of the most significant of these is the prohibition on purchases of mortgages from affiliates. This restriction effectively prohibits thrift holding companies from establishing financing subsidiaries which make mortgage loans that are to be sold to affiliate thrifts. This and other affiliate transaction rules applicable to thrifts must be modified to reflect present day realities.

-- The elimination or relaxation of debt-control

restrictions. To encourage additional capital flow into the thrift industry, the restriction must be lifted on the amount of debt non-diversified thrift holding companies and non-thrift affiliates can incur without prior written approval of the FHLBB.

-- Expansion of permissible thrift-related activities, including cross-marketing of products or services. If insured institutions comply with all the requirements designed to protect the insurance fund and other public policy interests, it is unnecessary to impose additional restrictions on the activities of the companies that own these institutions. Thrift holding companies are already sufficiently insulated from the insured subsidiary deposit institution to which the Savings & Loan Holding Company Amendments of 1967 envisioned the holding company would serve as a source of strength.

Other improvements can be made in the rules governing thrift holding companies that would allow more satisfactory profits and thereby encourage additional outside capital to come into the industry. The few reforms mentioned today would certainly improve conditions leading to the capitalization of the thrift industry.

With specific regard to H.R. 27, we are generally in agreement with the major terms of the bill. The effect of H.R. 27 should be to restore confidence in the integrity of the FSLIC

and in the fund's ability to fulfill its promise. We applaud the committee for working in this direction with the reintroduction of the FSLIC recapitalization concept widely considered in the previous Congress.

The bill offers an attainable objective with realistic milestones. A key element of H.R. 27 is to phase out the special assessment by FSLIC over a five-year period. The special assessment costs the industry $1 billion annually, while doing nothing to improve the actual capital base of the thrift industry. A five-year phase out is a compromise our membership is willing to accept.

Industry support of the bill will be enhanced if language is included which provides clear standards whereby the special assessment can be discontinued without relying on the discretion of the Bank Board.

Our association also agrees with these elements of H.R. 27:

-- We believe the scale of the proposed recapitalization is appropriate to the magnitude of the problem. Despite the price tag of this solution, and the consequent indirect cost to our members, we agree that public confidence in the deposit insurance fund can best be restored through a large injection of capital.

-- H.R. 27 will draw on surplus funds of the District Federal Home Loan Banks without creating risk contingencies that could threaten their future stability. This is in contrast to a recent alternative

proposal which could ultimately undermine the capital base of the whole thrift industry.

-- H.R. 27 provides a remedy for FSLIC which does not impose an inequitable burden on stockholder-owned thrift institutions, as would seem to be the effect of each alternative proposal we have seen. As members of this committee are aware, between 1981 and 1985, thrift holding companies have been by far the most meaningful source of assistance to the FSLIC and to the FHLBB to resolve the problems of troubled thrifts. We believe the future of the thrift industry will be dominated by those institutions with capable management which can attract new capital investment that will come from community investors and from those who invest in publicly traded thrifts.

-- H.R. 27 will establish a substantial reservoir of financial strength at the insurance level, which in turn allows thrift managers, depositors, and those who may wish to inject additional capital into thrift institutions to rely on the fund as a source of stability. This bill will achieve this stability without drawing on the American taxpayer for a bailout.

To enhance the prospects for approving a plan to recapitalize the FSLIC, we strongly believe that the recapitalization bill that goes forward should not include other issues. In the Chairman's letter requesting our testimony here

today, he noted that several members have indicated an interest in proposing amendments to H.R. 27 to deal with limitations on direct investments. The Bank Board is, of course, in the midst of an ongoing process designed to evaluate its two year experience with the current direct investment rule. It has received comment on that experience and is conducting public hearings later this month. The Board is carrying out precisely the rulemaking function for which independent regulatory agencies are designed.

The Board has committed to a schedule for developing a final rule on direct investments by March 15. There can be little doubt that some rule limiting direct investments will be adopted at that time. Both Chairman Gray and Board Member Henkel have indicated support for the proposal to limit direct investments, though they differ as to the appropriate method.

The Board is carrying out its rulemaking function in a responsible manner. It has opened its process to an unprecedented degree of public participation. We believe that, through this process, they can develop a rational and workable standard for regulating direct investment activity and provide appropriate protection for the FSLIC fund. There is no reason for Congress to pre-empt the Board's efforts. If, after the Board has taken final action, the Congress is not pleased with the resulting rule, there will be ample opportunity to legislate at that time.

With regard to our views on the investments themselves, let

me simply say this. We believe that the most significant cause of thrift industry problems today is not any particular kind of investment but rather the regional economic crises that are being experienced in several parts of the country. While direct investments have contributed to thrift industry failures, so have many other forms of investment, traditional and untraditional alike. The truth of the matter is that any area of investment activity can be mismanaged, can be subjected to fraudulent conduct, or can fall victim to a regional economic crisis.

The recapitalization problem is of such paramount importance that its consideration by the Congress should not be diluted by discussion of other matters, and Congress' attention to this problem should not be diverted to other issues which should be addressed separately.

Mr. Chairman, I again want to thank you for inviting the Association of Thrift Holding Companies to present its views on this vitally important issue. We appreciate your consideration of our points of view. I will be happy to answer questions and welcome the opportunity to present additional information for the record on behalf of our association.

Thank you.

Mario Obledo

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TO: BANKING, FINANCE, AND URBAN AFFAIRS COMMITTEE
CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20575

FROM: MARIO G. OBLEDO, ATTORNEY AT LAW

RE: AUTHORIZATION TO RECAPITALIZE THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION (FSLIC)

DATE: JANUARY 16, 1987

Due to the short notice given to me of the hearing on the request by the FSLIC for recapitalization of its financial base to carry on its duties, I am unable to make a personal appearance and thus I submit this brief statement for the record.

I oppose the recapitalization request until FSLIC fully explains to the Committee and to the Congress the management and operating practices, which have caused it to file this request to obtain capital.

The Committee must surely have information as to the number of savings and loan institutions which are presently being considered for receivership, which are in receivership, which have been liquidated, and which are being sued by FSLIC. It would be important to have the Chairperson and Chief Executive Officer of each of those institutions as a witness before this Committee to relate the actions of the FSLIC regarding their savings and loan associations.

I represent several former members of Presidio Savings and Loan Association, Porterville, California, who have been sued by FSLIC on various grounds. Suffice it to say that Presidio, in our opinion, was operating fairly well until the federal regulators started extensive monitoring procedures - in effect, operating the Association. The record reflects that once their interference commenced, the Association started experiencing difficulties that became unsurmountable. At that point, the Federal Home Loan Bank Board (FHLBB) placed Presidio in receiverhip under FSLIC, who then proceeded to further dissipate the Association assets. After emasculating Presidio, FSLIC liquidated the Association and now seeks to recover the losses from the former Board members.

This rather unjust situation could have been prevented had the FHLBB assisted Presidio through the issuance of net worth certificates, merger or consolidation advice, consultation on possible sale of the Association, or in a great variety of other ways. We believe Presidio could have been saved had it not been for the arbitrary and unreasonable actions of the federal agencies. Its loss was a loss to the community, but it also placed in jeopardy all those with whom the Association had conducted business.

Many of our financial institutions in this country are undergoing problems. Yet, the FHLBB focuses its resources against the smaller institutions, in this case, the only

Hispanic operated, predominantly Hispanic owned savings and loan association in California and the Southwest.

Because FSLIC has operated in such a loose and careless manner, spending money in reckless disregard of the taxpayer, it is now in a position of "negative net worth," the very situation they are responsible for trying to avert in the savings and loan industry. In essence, FSLIC has been expending money to lose money. This is unsound management, worse than the management complained about by the FHLBB in regards to the numerous savings and loan associations placed in receivership.

We believe corrective legislation is required to bring order to the operating practices and procedures of the FHLBB and FLSIC. Since this is a complex field of statutory and regulatory provisions, it may be prudent to conduct legislative hearings to gather information on what changes are needed. My cooperation in this regard is certainly offered.

A final note - The Hispanic population of the United States, and particularly of the Southwest, is growing at a tremendous pace. In Texas, we constitute at least 20% of the population; likewise in California. Yet, in neither state do we have a predominantly owned and operated Hispanic savings and loan association. The FHLBB and FSLIC have an obligation to assist this significant, identifiable community to have such an institution.

In conclusion, it is our desire that the recapitalization request by and for FSLIC be denied or, in the alternative, that action by the Committee be postponed until a full evidentiary hearing can be conducted on why the request became necessary and whether it is directly related to the possible incompetent management of the agency.

Respectfully submitted,

Mario G. Obledo

MARIO G. OBLEDO
(916) 441-5000

MGO:av

Additional Material Submitted for the Record

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515

January 14, 1987

Mr. Gerald J. Levy
Immediate Past Chairman
U.S. League of Savings Institutions
1709 New York Avenue, N.W.
Washington, D.C. 20006

Attn: Mr. Phil Gasteyer

Dear Mr. Levy:

As per staff discussions, the Committee requests your appearance at 10 a.m., on Wednesday, January 21, 1987, in Room 2128 Rayburn House Office Building to testify on the provisions of H.R. 27, a copy of which is enclosed.

As was pointed out in my statement on the occasion of the introduction of H.R. 27, a copy of which is also enclosed, the only difference between the bill and that passed by the House last year is the provision relating to GAO audit authority.

It is also quite likely that the subject of direct investments will be raised since several members have indicated an interest in proposing amendatory language reflecting the considerable concern over the recent publicity surrounding activities of the Federal Home Loan Bank Board. Therefore I am extending invitations to witnesses who will reflect opposing views concerning this subject and believe it to be appropriate for the U.S. League to be prepared to respond to questions concerning the subject matter.

In accordance with Committee rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building, Washington, D,C, 20515, 24 hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing records and, if delivered when requested, the statement will be made available to all Committee members in advance of the hearing. To provide all Committee members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to 10 minutes.

Sincerely,

Fernand J. St Germain

Fernand J. St Germain
Chairman

FJStG:bSh

Enclosures

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
2129 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

January 14, 1987

Mr. John Rousselot, President
National Council of Savings Institutions
1101 15th Street, N.W.
Washington, D.C. 20005

Dear Mr. Rousselot:

As per staff discussions, the Committee requests the appearance of a witness representing the National Council at 10 a.m., on Wednesday, January 21, 1987, in Room 2128 Rayburn House Office Building to testify on the provisions of H.R. 27, a copy of which is enclosed. Please furnish the name of your witness as soon as possible.

As was pointed out in my statement on the occasion of the introduction of H.R. 27, a copy of which is also enclosed, the only difference between the bill and that passed by the House last year is the provision relating to GAO audit authority.

It is also quite likely that the subject of direct investments will be raised since several members have indicated an interest in proposing amendatory language reflecting the considerable concern over the recent publicity surrounding activities of the Federal Home Loan Bank Board. Therefore I am extending invitations to witnesses who will reflect opposing views concerning this subject and believe it to be appropriate for the National Council to be prepared to respond to questions concerning the subject matter.

In accordance with Committee rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building, Washington, D.C. 20515, 24 hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing records and, if delivered when requested, the statement will be made available to all Committee members in advance of the hearing. To provide all Committee members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to 10 minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:bSh
Enclosures

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515

January 14, 1987

Mr. Patrick Forte, President
Association of Thrift Holding Companies
900 17th Street, N.W. Suite 500
Washington, D.C. 20016

Dear Mr. Forte:

As per staff discussions, the Committee requests the appearance of a witness representing the Association at 10 a.m., on Wednesday, January 21, 1987, in Room 2128 Rayburn House Office Building to testify on the provisions of H.R. 27, a copy of which is enclosed. Please furnish the name of your witness as soon as possible. In the event that a representative of the Association is unable to appear, we will, of course, accept a written statement from the Association which will be made a part of the hearing record.

As was pointed out in my statement on the occasion of the introduction of H.R. 27, a copy of which is also enclosed, the only difference between the bill and that passed by the House last year is the provision relating to GAO audit authority.

It is also quite likely that the subject of direct investments will be raised since several members have indicated an interest in proposing amendatory language reflecting the considerable concern over the recent publicity surrounding activities of the Federal Home Loan Bank Board. Therefore I am extending invitations to witnesses who will reflect opposing views concerning this subject and believe it to be appropriate for the Association to be prepared to respond to questions concerning the subject matter.

In accordance with Committee rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building, Washington, D.C. 20515, 24 hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing records and, if delivered when requested, the statement will be made available to all Committee members in advance of the hearing. To provide all Committee members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to 10 minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:bSh
Enclosures

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515

January 21, 1987

Mr. Gerald Levy
Immediate Past Chairman
U.S. League of Savings Institutions
1709 New York Avenue, N.W.
Washington, D.C. 20006

<u>Attention: Mr. Phil Gasteyer</u>

Dear Mr. Levy:

Thank you for your testimony at today's hearing on the Federal Savings and Loan Insurance Corporation (FSLIC) recapitalization plan. In order to complete the hearing record please provide written answers to the following questions:

1. On page 12 of your testimony, you stated that not only does the FSLIC have annual investment income, but you also predicted that the FSLIC will "soon" realize an "additional" inflow of cash from the disposition work of the Federal Asset Disposition Association (FADA). How soon will the FSLIC realize this inflow of cash and how much cash will this be? On what sources or calculations do you base these predictions? Please explain.

2. On pages 11 and 12 of your testimony, you explain basic elements of the U.S. League's recapitalization plan, including the establishment of the funding corporation, the issuance of zero-coupon bonds, the raising of up to $5 Billion dollars in two years, and the repayment of these bonds and borrowings. You stated, "If the bank system earnings fall short of our projections, FSLIC-insured institutions are prepared to make up the difference." Please explain this statement. Has the U.S. League conducted a survey of all FSLIC-insured institutions on this issue? Please explain.

I would appreciate your organization's timely response to these questions by January 31, 1987, as the Full Committee plans to mark up the FSLIC recapitalization plan in early February.

Again, thank you and I look forward to your reply.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:kTk

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515

January 21, 1987

Mr. David J. Sullivan, Jr.
Treasurer
The National Council
of Savings Institutions
1101 15th Street, N.W.
Washington, D.C. 20005

<u>Attention: Mr. John Rousselot</u>

Dear Mr. Sullivan:

Thank you for your testimony at today's hearing on the Federal Savings and Loan Insurance Corporation (FSLIC) recapitalization plan. In order to complete the hearing record please provide written answers to the following questions:

1. During the hearings, the question arose as to the number of National Council member institutions that are insured by the FSLIC versus those which are insured by the Federal Deposit Insurance Corporation (FDIC). Please provide this information and also indicate which FDIC insured institutions are chartered by the Federal Home Loan Bank Board.

2. On page 11 of your testimony, the National Council proposes imposing an exit fee equal to two years of regular premiums plus two years of "special assessments". As was discussed during the hearing, how did you determine that this exit fee was an adequate deterrent to prevent thrifts from leaving the FSLIC insurance fund? Please explain this and other alternatives that were considered to prevent institutions from switching from FSLIC to FDIC insurance.

I would appreciate your organization's timely response to these questions by January 31, 1987, as the Full Committee plans to mark up the FSLIC recapitalization plan in early February.

Again, thank you, and I look forward to your reply.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:kTk

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

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(202) 225-4247

January 21, 1987

Mr. Patrick A. Forte, President
Association of Thrift Holding Companies
900 17th Street, N.W., Suite 500
Washington, D.C. 20016

Dear Mr. Forte:

Thank you for your testimony at today's hearing on the Federal Savings and Loan Insurance Corporation (FSLIC) recapitalization plan. In order to complete the hearing record please provide written answers to the following questions:

1. On page 6 of your testimony, you stated that industry support of H.R. 27 would be enhanced by including standards whereby the special assessment could be discontinued without relying on the Federal Home Loan Bank Board's discretion. How would the marketplace view the discontinuance of the special assessment authority, as you appear to propose here?

2. As you know, the National Council of Savings Institutions, the Federal Home Loan Bank Board and the Department of the Treasury also strongly support the same FSLIC recapitalization plan, whereas the U.S. League has now submitted an alternative proposal. How does the Association of Thrift Holding Companies account for such a divergence of opinion within the industry regarding the FSLIC recapitalization plan? Also, please comment on the U.S. League's recapitalization proposal as outlined in Mr. Levy's testimony yesterday. (See enclosed).

I would appreciate your organization's timely response to these questions by January 31, 1987, as the Full Committee plans to mark up the FSLIC recapitalization plan in early February.

Again, thank you, and I look forward to your reply.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:kTk

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USL
UNITED STATES LEAGUE of SAVINGS INSTITUTIONS WASHINGTON OFFICE
1709 NEW YORK AVENUE, N.W. / WASHINGTON, D.C. 20006 / TEL. (202) 637-8900
PHILIP GASTEYER
Executive Vice President
& Director of Washington Operations

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Subcommittee on Financial Institutions

The Honorable Fernand J. St Germain
Chairman
Committee on Banking,
Finance and Urban Affairs
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman St Germain:

Thank you for this opportunity to elaborate further on the U.S. League's self-help, industry-underwritten program for resolving the problems of the Federal Savings and Loan Insurance Corporation. Following are responses to your written questions to us of January 21, 1987:

> Question #1.: On Page 12 of your testimony, you stated that not only does the FSLIC have annual investment income, but you also predicted that the FSLIC will "soon" realize an "additional" inflow of cash from the disposition work of the Federal Asset Disposition Association (FADA). How soon wil the FSLIC realize this inflow of cash and how much cash will this be? On what sources or calculations do you base these predictions?

Answer: The job of the Federal Asset Disposition Association (FADA) is to manage and assist as possible the FSLIC in its efforts to deal with the problem assets it acquires. Although we do not have access to precise data, we understand that FADA is currently managing over $1.0 billion in assets. Further, we believe that the structure is in place to permit FADA to manage roughly $5.0 billion in assets annually.

Given the problem nature of these assets, it is very difficult to project the cash flows FADA will produce for the FSLIC. For example, we might assume that FADA will have about $5.0 billion under management by the end of 1987. The asset resolution rate for FADA might range between 10% and 25% of assets managed per year. This suggests an annual cash flow to FSLIC from FADA of between $500 million and $1.25 billion for each year it manages an average of roughly $5.0 billion in assets.

We did not use such estimates in our proposed plan for two reasons: (1) So that the comparison of our plan to that of the Treasury would be clear, and (2) Due to the uncertainties surrounding where the assets will be located, market conditions and the precise nature of the assets involved, any such estimates are "ballpark" at best.

Still, we believe FADA will do a good job and provide significant benefits to the FSLIC. Clearly, the FSLIC will receive added cash flows as FADA operates although their precise size and timing is unknown.

Question #2.: On pages 11 and 12 of your testimony, you explain basic elements of the U.S. League's recapitalization plan, including the establishment of the funding corporation, the issuance of zero-coupon bonds, the raising of up to $5 billion dollars in two years, and the repayment of these bonds and borrowings. You stated, "If the bank system earnings fall short of our projections, FSLIC-insured institutions are prepared to make up the difference." Please explain this statement. Has the U.S. League conducted a survey of all FSLIC-insured institutions on this issue? Please explain.

Answer: The U.S. League has not conducted a specific survey of its membership on the FSLIC recapitalization issue. This is not the method in which the U.S. League develops its policy positions. Instead it appoints study groups on various issues and submits their recommendations to the governing bodies of the U.S. League.

The U.S. League's FSLIC funding plan was unanimously approved by a study group of more than 40 representative industry leaders and (again unanimously) by the our Legislative Policy Committee and our Board of Directors, which has representatives from all 50 states. Furthermore many of the state savings and loan leagues, including those from such large states such as California, Florida and New York, have endorsed our proposal.

Thus, we can confidently say that there is overwhelming support for the League's plan within the business. The various groups mentioned have also expressed steadfast opposition to the plan proposed by the Treasury Department and the Federal Home Loan Bank Board as contained in H.R. 27.

The Treasury's version authorizes a $3 billion investment by the Federal Home Loan Bank System in a Financing Corporation which, in turn, will use this amount to purchase zero-coupon bonds to defease principal on obligations of five times that amount (i.e., $15 billion) to be issued by the Financing Corporation which must mature within 30 years of issue (not beyond the year 2026). All debt service associated with these obligations must be borne by assessments on FSLIC-insured institutions. No direction is provided in the proposed statute on how quickly or in what increments the $15 billion in bonds is to be raised. When measured in present value terms, the cost of special assessments and debt service under the Administration's legislative request would be $15.5 billion for the next 20 years; by contrast, this burden would be $9.6 billion under the League's proposal -- promising a stronger FSLIC fund at that point.

The League's funding proposal contemplates a different contribution pattern from the FHLBank System, with a tap on future earnings (if earned) over a longer period rather than the upfront diversion of $3 billion in System retained earnings. (Both approaches make adjustments for equitable treatment of FDIC-insured institutions which belong to the FHLBank System.) Relying on future earnings instead of draining the FHLBank System's present retained earnings has the additional benefit of preserving the creditworthiness of the System for its day-to-day agency borrowing operations.

As indicated by your question, the League's testimony states that if future Bank System earnings fall short of the borrowings needed to bolster the FSLIC's reserves, FSLIC institutions themselves would make up the difference. This possibility is illustrated in greater detail in Exhibit 8 of the U.S. League's Task Force on FSLIC Issues provided to the Committee, and attached hereto for your convenience. The contributions of the FHLBank System and the shortfall to be made up by FSLIC-insured institutions are given under three scenarios: when FHLBank earnings are 9.5%; when those earnings do not grow at all; and when those earnings are at 5%. (For perspective, since 1978, System earnings have grown an average of 14% annually.)

Sincerely,

Phil Gasteyer

EXHIBIT 8: BORROWING CAPABILITY USING 20% OF BANK SYSTEM NET INCOME

ASSUMPTIONS:	
TOTAL BORROWINGS	$5.00 BILL.
NEEDED FUNDS IN TWENTY YEARS	$22.44 BILL.
NEEDED GROWTH RATE OF SYSTEM EARNINGS	9.53%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.00%

YEAR	NET INCOME	BANK SYSTEM CONTRIB-UTION	AMOUNT IN SINKING FUND	BORROWINGS OUTSTANDING PRINCIPAL & INTEREST
1986	$1,375			
1987	$1,506	$275	$275	$2,500
1988	$1,649	$301	$590	$5,200
1989	$1,807	$330	$949	$5,616
1990	$1,979	$361	$1,358	$6,065
1991	$2,167	$396	$1,822	$6,551
1992	$2,374	$433	$2,346	$7,075
1993	$2,600	$475	$2,938	$7,641
1994	$2,847	$520	$3,605	$8,252
1995	$3,119	$569	$4,355	$8,912
1996	$3,416	$624	$5,196	$9,625
1997	$3,741	$683	$6,139	$10,395
1998	$4,097	$748	$7,195	$11,226
1999	$4,488	$819	$8,374	$12,125
2000	$4,915	$898	$9,690	$13,094
2001	$5,384	$983	$11,158	$14,142
2002	$5,896	$1,077	$12,792	$15,273
2003	$6,458	$1,179	$14,611	$16,495
2004	$7,073	$1,292	$16,633	$17,815
2005	$7,747	$1,415	$18,880	$19,240
2006	$8,485	$1,549	$21,373	$20,779
2007			$22,442	$22,442
TOTAL	$81,749	$14,928		
PRESENT VALUE OF CONTRIBUTIONS		$5,838		

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EXHIBIT 8 (Contd.): SHORTFALL IF BANK SYSTEM EARNINGS DO NOT GROW

ASSUMPTIONS:	
TOTAL BORROWINGS	$5.00 BILL
NEEDED FUNDS IN TWENTY YEARS	$22.44 BILL
GROWTH RATE OF SYSTEM EARNINGS	0.00%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.00%

YEAR	NET INCOME	MINIMUM BANK SYSTEM CONTRIB.	SHORTFALL MADE UP BY THE BUSINESS	AMOUNT IN SINKING FUND
1986	$1,375			
1987	$1,375	$275	$0	$275
1988	$1,375	$275	$26	$590
1989	$1,375	$275	$55	$949
1990	$1,375	$275	$86	$1,358
1991	$1,375	$275	$121	$1,822
1992	$1,375	$275	$158	$2,346
1993	$1,375	$275	$200	$2,938
1994	$1,375	$275	$245	$3,605
1995	$1,375	$275	$294	$4,355
1996	$1,375	$275	$349	$5,196
1997	$1,375	$275	$408	$6,139
1998	$1,375	$275	$473	$7,195
1999	$1,375	$275	$544	$8,374
2000	$1,375	$275	$623	$9,690
2001	$1,375	$275	$708	$11,158
2002	$1,375	$275	$802	$12,792
2003	$1,375	$275	$904	$14,611
2004	$1,375	$275	$1,017	$16,633
2005	$1,375	$275	$1,140	$18,880
2006	$1,375	$275	$1,274	$21,373
2007				$22,442
TOTAL	$27,500	$5,500	$9,428	
AMOUNT OF DEBT COVERED		$2,127	$2,873	
PRESENT VALUE OF CONTRIBUTIONS		$2,700	$3,138	

EXHIBIT 8 (Contd.): SHORTFALL IF BANK SYSTEM EARNINGS GROW AT 5% P.A.

ASSUMPTIONS:	
TOTAL BORROWINGS	$5.00 BILL.
NEEDED FUNDS IN TWENTY YEARS	$22.44 BILL.
GROWTH RATE OF SYSTEM EARNINGS	5.00%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.00%

YEAR	NET INCOME	BANK SYSTEM CONTRIB.	SHORTFALL MADE UP BY THE BUSINESS	AMOUNT IN SINKING FUND
1986	$1,375			
1987	$1,444	$275	$0	$275
1988	$1,516	$289	$12	$590
1989	$1,592	$303	$27	$949
1990	$1,671	$318	$43	$1,358
1991	$1,755	$334	$61	$1,822
1992	$1,843	$351	$82	$2,346
1993	$1,935	$369	$106	$2,938
1994	$2,032	$387	$133	$3,605
1995	$2,133	$406	$163	$4,355
1996	$2,240	$427	$197	$5,196
1997	$2,352	$448	$235	$6,139
1998	$2,469	$470	$278	$7,195
1999	$2,593	$494	$326	$8,374
2000	$2,722	$519	$379	$9,690
2001	$2,859	$544	$439	$11,158
2002	$3,001	$572	$505	$12,792
2003	$3,152	$600	$579	$14,611
2004	$3,309	$630	$661	$16,633
2005	$3,475	$662	$753	$18,880
2006	$3,648	$695	$855	$21,373
2007				$22,442
TOTAL	$47,739	$9,093	$5,835	
AMOUNT OF DEBT COVERED		$3,251	$1,749	
PRESENT VALUE OF CONTRIBUTIONS		$3,948	$1,889	

National Council of Savings Institutions

John H. Rousselot
President

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Subcommittee on Financial Institutions

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Banking, Finance & Urban Affairs Committee

January 30, 1987

The Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance and Urban Affairs
2129 Rayburn House Office Building
Washington, D. C. 20515

Dear Mr. Chairman:

This is in response to your letter of January 21, 1987, that included two follow-up questions to the testimony delivered on behalf of the National Council by Mr. David J. Sullivan, Jr.

First, with respect to the insurance status of the members of the National Council, approximately two-thirds of our member institutions are FDIC insured. However, of the approximately $430 billion in insured deposits held by National Council members, $172.7 billion, or 40.1 percent, are FDIC insured, and $257.7 billion, or 59.9 percent, represent deposits insured by the FSLIC. The National Council's Task Force studying FSLIC recapitalization was likewise evenly divided between institutions that are FDIC insured and those which are FSLIC insured. That task force was chaired by Mr. George Rutland, Vice Chairman and CEO of California Federal Savings and Loan Association, a $20 billion FSLIC-insured institution.

With respect to the question of exit fees, this is a matter to which the National Council has given a great deal of study. Upon consulting with the institutions directly affected (both acquirors and acquirees), we have proposed a compromise exit fee equal to two years of regular premiums and two years of special assessment, or roughly five years of insurance premiums. We have arrived at this figure utilizing as a starting point current law which, as a result of the recent federal court ruling in Florida*, is that the FHLBB lacks authority to impose any exit fee when an institution converts from federal to state charter as part of its ultimate conversion to FDIC insurance.

The two years exit premium mentioned in the original National Housing Act of 1933 [12 U.S.C. 1730(d)] was intended and has been

* <u>United First Federal Savings and Loan Association, et al.</u> v. <u>Federal Home Loan Bank Board</u>, No. 86-661-Civ-J-16, Middle District of Florida, December 19, 1986, <u>appeal docketed</u> 86-3863 11th Cir., 1987.

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The Honorable Fernand J. St Germain
January 30, 1987
Page 2

consistently administered over the course of fifty years to apply only when an institution surrenders FSLIC insurance for state insurance or non-insured status. Thus, we feel our suggested compromise represents a reasonable middle ground between no exit premiums, which was the result in the above-referenced case as well as the recent transaction involving the merger of Westchester Federal Savings and Loan into Marine Midland Bank, and the ten years exit fee being advocated by the FHLBB.

We trust that you will find the foregoing to be responsive to your inquiry. If you should require any further information, we would be very pleased to furnish it.

Kind regards,

John H. Rousselot

John H. Rousselot

ASSOCIATION OF THRIFT HOLDING COMPANIES
900 17th Street, N.W., Suite 500
Washington, D.C. 20006
(202) 223-6575

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FEB 2 1987

Banking, Finance & Urban Affairs Committee

BY MESSENGER

January 30, 1987

The Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance & Urban Affairs
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. St Germain:

Following the presentation of testimony by the Association of Thrift Holding Companies at the hearings on the Federal Savings and Loan Insurance Corporation (FSLIC) recapitalization plan, you requested that the Association provide written answers to certain questions in order to complete the hearing record. We are pleased to do so.

1. Your first question referred to page six of the Association's testimony (copy attached), where it was stated that industry support of H.R. 27 would be enhanced by including standards whereby the special assessment could be discontinued without relying on the Federal Home Loan Bank Board's discretion. Your query was: "How would the marketplace view the discontinuance of the special assessment authority, as you appear to propose here?"

The Association of Thrift Holding Companies emphasized in its testimony that the special assessment should be phased out over a period of no more than five years, with inclusion of language in H.R. 27 which provides clear standards whereby the special assessment will be discontinued without requiring any action or exercise of discretion by the Bank Board.

In our opinion, the existence of clear standards in the legislation will dictate the marketplace reaction to discontinuance of the special assessment authority. If there is certainty -- if a mechanism is spelled out in the act -- then the view of the marketplace toward equity or debt issues of thrift holding companies (and individual stock thrifts) will be positive, because investment analysts will be able to take that development into account in developing their projections of earnings. However, if the happening of the event must hinge on regulatory fortuity, there will be uncertainty -- and that discourages investment.

The key objective of H.R. 27 is to improve the capital base of the thrift industry. Attraction of capital is much, much easier if future events may be predicted with some certainty.

For that reason, it is imperative that the timing of the discontinuance of the special assessment be predictable. That is only possible if there are clear standards in the legislation.

Obviously, predictable discontinuance of the special assessment is viewed favorably in the industry, because the special assessment is an expense which detracts from earnings. However, in the market, general industry approval does not necessarily create an incentive for those with the necessary capital to invest in thrifts. That incentive is only created if the timing of the discontinuance can be precisely predicted, so that it can be incorporated in investment strategy.

2. Your second question referred to the alternative proposal for FSLIC recapitalization submitted by the U.S. League, and asked how the Association of Thrift Holding Companies accounts for such a divergence of opinion within the industry regarding the FSLIC recapitalization plan. You also requested comment on the U.S. League's recapitalization proposal as outlined in Mr. Levy's testimony.

The Association of Thrift Holding Companies believes that there is a divergence of opinion within tha industry regarding tha extent of FSLIC recapitalization because there are differing assessments of the magnitude of the underlying problem. It is completely natural that the large traditional segment of the industry itself, as represented by the League, may have a more hopeful view of its economic circumstances than those with the perspective of investors or regulators.

Another reason why there is divergence of opinion within the industry is because different analysts think different factors are important in characterizing the problem. Fundamental to this are mechanisms available to FSLIC to acquire the money to help troubled thrifts. Several unclear factors are: (1) If the Federal Home Loan Bank System advences money which comes from borrowings in the public debt markets, what level of borrowing is judicious, and what are the public policy side effects?; (2) If FSLIC is guaranteeing such advances, what level of reserves must it have?

It is entirely predictable, furthermore, that a complicated problem will have several proposed solutions. Thus, assuming there is agreement that FSLIC recapitalization is necessary, that leaves the question of how much recapitalization is necessary now, and what is the best mechanism to achieve it. The League's regional approach, including a forbearance program, is one suggested mechanism, with political appeal because it incorporates special attention to regional problem areas. We strongly support a program incorporating a forbearance element.

However, the larger threat to the industry is its ability to raise private capital along with an adequate FSLIC recapitalization, and political appeal does not itself create necessary capital. Thus, other segments of the industry suggest a more hard-headed, economic solution to the recapitalization problem.

There is a very real danger to the divergence of opinion regarding recapitalization of FSLIC, and that is that nothing will be done. Failure to act on recapitalization could precipitate a crisis which could throw the entire financial community into turmoil. Presumably, even the League agrees that this is an undesirable outcome.

Very truly yours,

Patrick A. Forte
President

PAF:my
Enclosure

U.S. LEAGUE OF SAVINGS INSTITUTIONS

REPORT OF THE TASK FORCE ON FSLIC ISSUES

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Chicago, IL

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U.S. League of Savings

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U.S. League Consultant
Beverly Hills, CA

Kermit L. Mowbray
President
FEDERAL HOME BANK OF TOPEKA

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PREFACE

This report proposes a two-part program for easing the pressures on the Federal Savings and Loan Insurance Corporation. While it addresses the agency's funding problem, it also places great emphasis on a series of initiatives aimed at the special problems of institutions located in economically depressed areas.

Calls for the injection of funds into the FSLIC have dominated the legislative agenda of the congressional banking committees for the past two years. Yet despite the many hundreds of hours of debate on the subject, it is still not possible to define the dimensions of the problem with any degree of precision. <u>The plain and simple fact is that nobody really knows in dollar terms what the costs of the problems of the FSLIC will be.</u>

Consequently one of our goals was to help set up a flexible program that can be adapted to meet whatever future financial demands are placed on the FSLIC and the federal deposit insurance systems in general. The program developed by the League substantially meets the funding objectives of the plan advocated by the Treasury Department and the Federal Home Loan Bank Board last year.

But also of great importance, it is becoming clear that any program for dealing with federal deposit insurance today must recognize the existence of what might be called areas of regional depression in the United States. These regions begin in the energy belt, extend to the farm belt and touch on states with economies depending on forest products, mining and other industries.

As some of the exhibits in this report show, there is obviously a pattern here, and the FSLIC's problems are heavily concentrated in these depressed areas. This report is also intended to contribute to a broader recognition in Congress and among the public generally of the need to take special measures to ease the great economic strains in these areas.

Consequently, rather than simply focusing on funding, our program recommends a number of regulatory, supervisory and accounting initiatives aimed at dealing with the special problems of institutions in these seriously depressed localities.

<u>As this report also demonstrates, the commercial banking regulators are already taking this kind of approach in depressed states and regions. As will be seen, our program borrows heavily from what the commercial banking regulators are already doing.</u>

We believe that if we can buy time through this program and preserve many well-managed institutions now in trouble simply because of local economic conditions beyond anyone's control, the communities these institutions serve will be better for it and the burden on the FSLIC's insurance fund will be that much less.

EXECUTIVE SUMMARY

Much has changed since the first formal proposals to provide additional new funds for the FSLIC were made in early 1986. Most notably, it has become clear that economic conditions in the nation vary significantly by state and even local communities. As a result, some key assumptions underlying the several FSLIC refunding proposals advanced in 1986 are no longer valid.

(These early plans included one proposed by the U.S. League in March, 1986; one proposed at approximately the same time by the Treasury and the Federal Home Loan Bank Board, and an alternative "Pay-As-You-Go" plan proposed by the U.S. League later in 1986.)

Originally, it was assumed thet there was a limited, one-time bulge in the FSLIC's case load that had to be dealt with on an extraordinary basis over the next few years. But as the U.S. League's reactivated Task Force on FSLIC Issues reviewed the situation facing the FSLIC as 1986 drew to a close, it found that this was not the case. Instead, it found that the deepening economic depressions in various states are creating major difficulties for both savings institutions and commercial banks in those areas. In fact, many states could see their financial institution infrastructure dissolve unless special provisions are made.

Many well-managed institutions are being overwhelmed by local economic conditions which resemble those of the 1930s. The severity of the situation is emphasized by the fact thet problems are no longer confined to commercial real estate problems -- large numbers of traditional single-family loans are now turning up in the non-performing categories in some areas.

<u>Thus, the capital of many institutions in these areas is now being eroded by operating losses from the lack of earnings on non-performing assets. These problems are being compounded by the use of the powerful provisions of the classification of assets regulation which when combined with the depressed local economic environment means that many well-run institutions can be written into insolvency</u>.

The Task Force believes this now situation requires a new approach to resolving the FSLIC's problems, and that our two-pronged "Savings Institutions Self-Help Plan" is the kind of now approach that should be taken.

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<u>this kind of ppro in ep se and gi will , our program</u>
<u>This is similar to the approach already being used in the commercial banking business.</u>

<u>Second, we believe the FSLIC should be provided with additional funds under a blending approach that combines parts of the U.S. League's 1986 "Pay-As-You-Go" Plan and the Treasury/Bank Board Recapitalization Plan also proposed last year.</u>

PART 1 -- FORBEARANCE FOR INSTITUTIONS IN DEPRESSED AREAS

As detailed in the body of this report and in Appendix A, there is ample precedent for the "two-tiered" approach to the regulation and supervision of savings institutions recommended in this program. A number of steps were taken to buy time early in this decade when the majority of savings institutions were suffering losses because of savings-rate deregulation and high interest rates, and in 1986 Congress legislated regulatory accounting provisions for the Farm Credit System.

Of particular significance, in 1986 the three federal commercial bank regulatory agencies embarked upon a program of supervisory forbearance toward well-managed commercial banks located in areas that depend heavily on agriculture or energy. Banks were encouraged to work with troubled energy borrowers. The regulators established a capital forbearance policy, relaxed lending limits, and encouraged the use of the provisions of generally accepted accounting principles that allow them, in certain circumstances, to continue carrying low paying or non-paying loans on their books without having to write them down.

Like the forbearance policy for commercial banks, the U.S. League's program also offers this kind of "breathing space" for well-managed savings institutions, and will ease potential future burdens on the FSLIC.

Specifically, the Task Force recommends that the Federal Home Loan Bank Board take the following three actions:

1. **Issue a policy statement directing the Principal Supervisory Agents (PSAs) to exercise forbearance in handling well-managed institutions in trouble due to local economic conditions.**

2. **Consistent with the commercial bank regulators' joint statement, the Federal Home Loan Bank Board should require savings institutions to account for problem assets according to GAAP.**

exercise forbearance in handling wellenBanksBoainstitutions in trouble due to regulations:

* **The asset classification regulation should use valuation standards consistent with GAAP in establishing the carrying value of assets.**

* **Appraisal Memorandum R41c should be rescinded immediately and its predecessor, Memorandum R41b, should be accepted instead as an interim**
Th asse classification regula on should us va uation standards onsistent
Memorandum R41b is used to determine asset carrying values for existing
Appraisal dMemorandum R 1c should rescinded immediately and its
which is consistent with GAAP.

* **Confine its use of the scheduled item approach to single family and two- to four-family residential mortgages. Also, the residual value after any write-down of income producing repossessed one- to four-family properties would not be subject to the additional 20 percent capital requirement.**

Together, this package of regulatory and supervisory actions will make it possible for many well-managed savings institutions in economically depressed areas to survive and continue serving their local communities. Even though the economic dislocations in some of these areas are great and will require major restructuring on the local level, well-managed institutions adapting to these changes with sound and realistic business plans must be given the opportunity to survive.

This policy will also help forestall the need for the FSLIC to take over the assets of many of these institutions and dispose of them at unrealistically low, "fire-sale" levels, which would be inevitable because these institutions are concentrated in regions already mired in economic depression. In turn this would further depress local real estate values, compounding problems for remaining insured depository institutions and making the depression worse.

The policy statement (Recommendation #1) is of particular importance. In addition to formally articulating a policy of forbearance, it should direct PSAs to consult with state savings institution commissioners in granting forbearance and allow PSAs to lower capital requirements for specific institutions. A statement of this kind would make it clear throughout the FHLB System that rules and regulations designed to curb unsound practices are not applied so indiscriminately that they worsen the problems of well-managed institutions in trouble merely because of general economic circumstances beyond their control.

The recommendation applying generally accepted accounting principles to the treatment of loans (Recommendation #2) would permit savings institutions to account for problem loans according to Statement of Financial Standards 15 (SFAS 15) just as commercial banks do. Also, it would alter the Bank Board's appraisal guidelines which require many well-run institutions to recognize excessively large losses on problem assets and to incur needless expense in having properties reappraised. (See Appendix B for a discussion of accounting methods.)

The third part of the recommendation would eliminate a problem that arises when, in assessing risk on a loan portfolio, certain non-traditional types of loans are subject both to the scheduled items approach and to the classification of assets system. This can result in a "double hit" to an institution where it must both add to its reserves if the asset is classified as doubtful and increase its net worth if the loan also becomes a scheduled item -- and of course there is a heavy concentration of problem loans in economically troubled areas.

PART 2 -- FUNDING FOR THE FSLIC

Despite dire predictions, the reality about the financial condition of the FSLIC is less grim. Although commentators have suggested that the fund would be down to $1 billion in resources by the end of 1986, on September 30, 1986, the agency had cash and government securities on hand of $4.6 billion.

Nevertheless, additional resources should be provided to the agency, and last year the U.S. League developed a funding proposal that would provide comparable resources to the FSLIC as one developed by the U.S. Treasury and the Federal Home Loan Bank Board. The difference in the two plans was a modest one of timing, with the funds being collected on a pay-as-you-go basis in the U.S. League's alternative.

The Treasury/Bank Board proposal would have required borrowing $10 to $15 billion "up front", burdening the business with huge interest payments for up to 20 years or more. The concern in the savings institution business was that these enormous "front-end" borrowings would mortgage its future. (For a discussion of the background of FSLIC recapitalization plans, see Appendix C.)

Critics of the U.S. League's approach charged that it did not provide enough resources to the FSLIC in the early years, and that if the FSLIC's problems proved larger than expected there was no way to provide more funds.

The U.S. League has re-examined its position with the goal of developing a solution to the FSLIC's funding needs that will be acceptable to all parties. The result is a blending of the "pay-as-you-go" approach with a modest bonding approach.

Specifically, the League has developed a three-part program for providing funds to the FSLIC:

RECOMMENDATION #1:

The Savings Institution Self-Help Program for funding the FSLIC. This funding proposal is explained below.

RECOMMENDATION #2:

Restore the legal framework governing the FSLIC's secondary reserve to its condition prior to the Garn St Germain act of 1982.

The Garn-St. Germain act included language in Section 126 permitting the secondary reserve to be used on the same basis as the primary reserve. Previously, the secondary reserve was to be tapped only to cover FSLIC losses and was to be used only to the extent other funds were unavailable -- restrictions flowing from the fact that the funds in the secondary reserve represent prepaid insurance premiums that were intended to be refunded over time.

These restrictions are needed to help convince the accounting profession that savings institutions should continue to carry their investment in the secondary reserve as an asset on their books. While the 1982 changes were justified under extreme conditions than existing, there is no need for their continuation in the context of the additional funds being provided to the FSLIC by the funding program.

RECOMMENDATION #3:

Extend the provisions of Section 597 and Section 368(a)(3)(D)(ii) of the tax code beyond their expiration date of January 1, 1989.

In dealing with the caseload of the FSLIC on the schedule common to both the Treasury/Bank Board and the U.S. League versions of an FSLIC recapitalization plan, it is important to recognize the necessity of retaining two provisions, enacted in 1981 as part of the tax code changes at that time, which reduce hard dollar FSLIC outlays in problem resolutions.

These tax code provisions are Section 597 and Section 368(a)(3)(D)(ii). The first extends tax-free status to FSLIC dollars expended to resolve a problem case and the second permits an acquirer of a problem case to use the shelter of the net operating loss carryforwards of the acquired institution. In the recently adopted revisions of the tax code, these two provisions were extended until January 1, 1989, but it is essential to extend them for at least a further three years, as originally recommended by the Treasury
extend them for at least a further three years, as originally recommended by the Treasury
the FSLIC can be used to maximum effect in case resolutions.

THE SAVINGS INSTITUTION SELF-HELP PROGRAM FOR FUNDING THE FSLIC

The Self-Help funding program would involve three steps:

1. If needed, the business would continue to pay the special insurance assessment, first levied at the beginning of 1985, on a six-year phase-down schedule. The assessment would drop to 83.33% in 1988, 66.67% in 1989, 50% in 1990, 33.33% in 1991, 16.67% in 1992 and 0% thereafter.

2. If needed, a funding corporation set up by the plan would be authorized to issue zero-coupon bonds. They would be repaid from the 20% of net income tha Federal Home Loan Bank System currently sets aside in the "legal reserve", which is not available to pay dividends to member institutions.

3. With the savings institution business being potentially asked to contribute huge amounts of resources to the FSLIC, the Bank Board should be accountable for their use by the insurance fund. Therefore, an oversight committee with representatives from the business would be statutorally established, the Bank Board would be required to report periodically to Congress on the use of the funds and the authority to continue to raise funds via the funding corporation would be subject to annual Congressional scrutiny.

With respect to Step 1, it must be emphasized that over the past two years the nation's savings institutions have paid more than $2 billion in special FSLIC assessments over and above the regular insurance premiums. Because of the special premium, a savings institution pays at least two-and-one-half times as much in insurance premiums as an equivalent sized commercial bank. And in addition to the inequitable treatment, the special assessments are encouraging stronger savings institutions to migrate from the FSLIC system to that of the Federal Deposit Insurance Corporation.

If the FSLIC's cash resources fall below some specified level, the funding corporation proposed in Step 2 would have authority to raise up to $2.5 billion in zero-coupon borrowings in the program's first year and another $2.5 billion in the second year (See Appendix B for details). If the Bank System's earnings do not grow quickly enough, it is possible the 20% of net income might not be sufficient to retire the principal and accrued interest on the bonds. In that case, the difference would be made up by assessments on the business.

The phased-down special assessment is estimated to provide the FSLIC with an additional $4.6 billion between 1987 and 1992. (This assumes that the business' deposits continue to grow at their estimated 1986 rate of 6 porcent per year.) Combined with the FSLIC's regular premium income, this would provide the FSLIC with a total cash flow of $20 billion over the next 10 years.

Consequently, the industry's Self-Help Plan would give the FSLIC virtually the same funding, if events so warrant, as that provided by the Treasury/Bank Board Plan, as shown in the following table:

FSLIC CASH FLOW FROM EXTERNAL SOURCES UNDER INDUSTRY SELF-HELP PROGRAM AND TREASURY/BANK BOARD PLAN

Cash Flow Over:	U.S. League Savings Insts. Self-Help Program	Treasury/Bank Board Program: $10 Billion in Borrowings	Treasury/Bank Board Program: $15 Billion In Borrowings
2 Years	$ 8.9 Billion	$ 8.7 Billion	$ 9.6 Billion
5 Years	$13.8 Billion	$16.8 Billion	$21.4 Billion
10 Years	$20.0 Billion	$19.0 Billion	$21.6 Billion
20 Years	$38.7 Billion	$29.7 Billion	$28.3 Billion

The sources of this cash flow are shown in the table on the following page and in more detail in Exhibit 1 at the end of this report.

Over the next two years, the League alternative will provide $200 million more to the FSLIC than the Treasury/Bank Board plan if $10 billion were borrowed in tha latter. Even if $15 billion were borrowed instead of $10 billion, the League's plan would provide only $700 million less over the next two years.

Over the long haul, the FSLIC fares much better in the League's preposal since it is not burdened with the heavy debt service of the Administration plan. Only when one looks at a five-year time-horizon does the FSLIC fare better in the Treasury/Bank Board plan.

However, the League's position is that, because of the uncertainty as to the size of the problem, a program should bo put in place to cover the next two years rather than having a five- or six-year program which burdens tha system with heavy interest payments into the next century.

After two years, if the situation remains critical, tha Congress should have the opportunity to revisit the question and, since the Self-Help program does not touch the current retained earnings of the Federal Home Loan Bank System, there is enough flexibility to be able to provide more resources at that time if Congress so directs.

The advantages of the U.S. League's new self-help program include the following:

*. It will provide the FSLIC with $8.9 billion over the next two years. With its other resources, this will give the FSLIC an inflow of funds over the next two years of $10 billion or more, or an average of $5 billion a year. This is $1.5 billion more in expenditures than the record level of fiscal 1986.

* It is a flexible plan, and does not consider touching the $2.2 billion the Federal Home Loan Bank System currently holds in retained earnings.

SOURCES OF FSLIC EXTERNAL CASH FLOW UNDER ALTERNATIVE PROPOSALS

	U.S. League Savings Insts. Self-Help Plan	Treasury/ Bank Board $10 B.	Treasury/ Bank Board $15 B.
TWO-YEAR CASH FLOW:			
Regular Premiums	$1.6 B.	$1.6 B.	$1.6 B.
Special Assessments	$2.2 B.	$2.2 B.	$2.2 B.
Borrowings	$5.0 B.	$5.0 B.	$6.0 B.
Subtotal	$8.9 B.	$8.9 B.	$9.9 B.
less			
Interest on Debt	$0.0 B.	$0.0 B.*	$0.0 B.*
TOTAL	$8.9 B.	$8.7 B.	$9.6 B.
TWO-YEAR CASH FLOW:			
Regular Premiums	$4.5 B.	$4.5 B.	$4.5 B.
Special Assessments	$4.5 B.	$4.5 B.	$4.3 B.
Borrowings	$5.0 B.	$10.0 B.	$10.0 B.
Subtotal	$13.8 B.	$18.8 B.	$23.8 B.
less			
Interest on Debt	$0.0 B.	$5.0 B.*	$2.4 B.*
TOTAL	$13.8 B.	$16.8 B.	$21.4 B.
TEN-YEAR CASH FLOW:			
Regular Premiums	$10.4 B.	$10.4 B.	$10.4 B.
Special Assessments	$4.6 B.	$4.6 B.	$4.6 B.
Borrowings	$5.0 B.	$10.0 B.	$10.0 B.
Subtotal	$20.0 B.	$25.0 B.	$20.0 B.
less			
Interest on Debt	$0.0 B.	$6.0 B.*	$8.4 B.*
TOTAL	$20.0 B.	$19.0 B.	$21.6 B.
TWENTY-YEAR CASH FLOW:			
Regular Premiums	$29.1 B.	$29.1 B.	$29.1 B.
Special Assessments	$4.6 B.	$4.6 B.	$4.6 B.
Borrowings	$5.0 B.	$10.0 B.	$10.0 B.
Subtotal	$38.7 B.	$43.7 B.	$43.7 B.
less			
Interest on Debt	$5.0 B.	$14.0 B.*	$20.4 B.*
TOTAL	$38.7 B.	$29.7 B.	$28.3 B.

* Under the final version of the Treasury/Bank Board plan, the FSLIC does not actually pay the interest on the borrowings. Instead, the interest on the borrowings represent a first call on the premiums and/or assessments from the business. However, the interest payments are broken out as a separate obligation of the FSLIC in this table for the sake of clarity the net effect is the same. Under the League's self-help plan the Bank System (and perhaps the business) pays the interest.

* Over the next 20 years, it is far cheaper than the Treasury/Bank Board proposal.

The question has been raised as to whether there is a cost to the FSLIC in delaying action in the final resolution of problem cases. But as detailed in Appendix D, the Bank Board has many ways of assuring that institutions under its control do not continue to increase risks to the deposit insurance fund.

These include replacing managements and boards of directors, or putting institutions in the Management Consignment Program. Certainly all responsible savings institutions, already burdened with billions of dollars in special insurance assessments, will demand that the Board ensure that other institutions are not allowed to continue to act in a manner likely to cost the industry even more money. And assets taken over by the FSLIC can be conserved through the Federal Asset Disposition Corporation.

In fact too rapid an approach to the disposition of problem assets can actually be expensive for the FSLIC. As noted earlier, with problem assets concentrated in a few states and regions, notably those already in deep economic trouble, the assets would have to be disposed of at fire-sale prices. In turn, this would further erode local real estate values generally, creating problems for all financial institutions in the area and making the depression worse.

The situation is much like that early in this decade. According to calculations by the Government Accounting Office, by taking an essentially wait-and-see attitude the FSLIC saved itself approximately $4.7 billion, which almost precisely equals the $4.6 billion in cash and securities the FSLIC had on hand at the end of September, 1986. Were it not for those savings, the FSLIC would now be totally out of money. (See Appendix A.)

I: FORBEARANCE FOR INSTITUTIONS IN DEPRESSED AREAS

Effects of the tremors that have rocked the American financial system over the past 10 years continue to be felt. First came historical extremes in inflation and in the level and volatility of interest rates. These are natural enemies of all financial institutions -- and especially of long-term lenders.

The federal government's solution for financial institutions was to deregulate interest rates on deposits. But while deregulation was designed to strengthen the system ultimately, it was implemented at the expense of eliminating or severely weakening institutions which were not prepared to survive the transition.

Deregulation also brought with it the temptation for some financial institution managers to take new and greater risks than traditionally deemed prudent for such lenders. Some particularly risky strategies assumed that the inflation which caused so much trouble would become a permanent fixture of the economy. Problems stemming one way or another from inflation (and subsequent deflation) and high interest rates are generally blamed for the difficulties now facing the agencies that provide federal deposit insurance.

However, far less attention has been directed at another perplexing phenomenon with a great impact on financial institutions: The growth, and now the coexistence, of two separate and decidedly unequal economies in the United States.

On the one hand, the economy as a whole has entered the fifth year of a relatively stable recovery from the severe recession of 1982, one of the longest recoveries on record. While a recession or at least a pause in the recovery could occur at any time, the economy is generally strong, and some of its most serious problems now appear resolved. Inflation has been brought under control. Interest rates have subsided and seem likely to remain low for the immediate future, and some regions, notably the Northeast, are thriving.

Similarly, by most measures the savings institutions business as a whole is performing better than ever. Earnings, interest rate spreads, lending volume and other indicators are at or above historic highs at the vast majority of institutions. A business that some were predicting just a few years ago would fade away or be absorbed into more general purpose types of financial institutions, such as commercial banks, has turned itself around. Along with producing these gratifying results, most savings institutions have made impressive progress in reducing their exposure to the interest rate risk that caused them such problems early in the decade.

The generally favorable picture for the economy and the savings institutions business is marred, however, in that both are seriously depressed in some parts of the country.

Sharp downturns in certain industries have hit some cities, regions and states so hard that financial institutions serving these areas are under extraordinary strains. Bad weather, weak demand for American food exports, poorly timed changes in world and U.S. agricultural policies and depressed food prices have contributed to one of the worst periods for farmers in American history.

The world oversupply of oil and gas and the resultant fall in prices of all fossil fuels have turned the booming oil and gas producing states -- and less prosperous coal dependent regions -- into economic wastelands. Overseas competition in the production of minerals, timber, steel and other materials have hit those industries hard. Exhibit 2 shows the 18 states currently experiencing the greatest economic hardships as measured by unemployment, personal income and housing starts.

Assigning responsibility for these dislocations is not the subject of this report. It is sufficient to note that the affected financial institutions themselves did not bring about the economic distress plaguing them and their areas.

Among financial institutions, commercial banks are hit first and hardest when the industry an area relies on suffers a downturn. As Exhibit 3 shows, two states, Texas and Oklahoma, account for more than one-fourth of tha commercial banks closed by regulators in the past two years. Another 40 parcent of the closings in those two years occurred in the 10 states that constitute the Midwestern farm belt. As is shown in the map in Exhibit 4, energy- and agriculture-dominated states in other parts of the country also have large numbers of closings.

It is easy to see why the commercial banking industry's fate in a given region closely parallels that of the economy as a whole. Bank credit continues to be the lifeblood of small and medium enterprises such as many farms and energy producers. If a grain farmer is unable to recover the production costs because of low food prices, the bank from which he borrowed for seed, fertilizer end equipment loses too. The harvest that was collateral is likely to be worth far less than the loan balance.

But if banks are the first to suffer, the next wave of trouble engulfs lenders who hold mortgages. As farm operations sour, people in the service and manufacturing businesses that support agriculture lose their jobs, other parts of tha region's economy suffer, and eventually the quality of mortgage debt and loans for other household purposes declines along with business debt.

The impact of economic distress on savings institutions is graphically portrayed in the maps in Exhibit 5, which highlight states where savings institutions, on the average, had poor operating results in the first half of 1986. These maps overlap closely the previous ones showing general economic stress and commercial bank difficulties in various states, suggesting that most problems in these states are systematic.

Whatever criteria are used to define areas where financial institutions are having difficulties because of local economic problems, it is clear there is at least some causal relationship. In areas heavily dependent on certain currently depressed industries, financial institutions are experiencing far more trouble than those located elsewhere or the average institutions nationwide.

Recognizing the emergence of this "two tiered" economy, the U.S. League has drawn up a series of recommendations to diminish the imminent pressures on the Federal Savings and Loan Insurance Corporation while buying additional time for savings institutions in economically depressed regions to recover from tha temporary adversity facing them.

There is ample precedent for this approach in past situations involving savings institutions and, especially, commercial banks.

Early in this decade, when the majority of savings institutions were suffering losses because of savings-rate deregulation and high interest rates, a number of steps were taken to buy time. Congress authorized the Net Worth Certificate program and the regulators allowed many institutions to operate below minimum capital standards.

Responding to the growing crisis in the agricultural sector, in 1986 Congress legislated regulatory accounting provisions for the Farm Credit System.

Even more significantly, in the same year the federal commercial bank regulators adopted a program of supervisory forbearance to assist "basically sound, well-managed banks to weather this transitional period" of economic hardship in parts of the country dominated by the agriculture and timber, energy production and mining industries. (A description of the commercial bank regulators' forbearance plan and of other relevant forbearance models is given in Appendix A to this report).

In an implementing statement, the Comptroller of the Currency declared that the program's elements included encouraging banks to work with troubled agricultural and oil and gas borrowers, establishing a capital forbearance policy, relaxing lending limits, and encouraging "the use of generally accepted accounting principles which may permit loan restructurings without less recognition."

The Comptroller's statement formally acknowledged that "capital should be used during periods of unusually heavy loan losses and that capital replenishment takes time." It specified that the OCC would not take administrative action to enforce minimum capital requirements where the bank is an agricultural or oil and gas lender, and its weakened capital position is due to problems in these sectors of the economy. Affected banks were also given permission, in certain circumstances, to continue carrying slow paying or non-paying loans without recognizing them as losses.

The actions recommended in the U.S. League's program would offer the same kind of "breathing space" as the forbearance policies of the commercial bank regulators adopted in early 1986.

At the same time, these steps would alleviate or possibly eliminate some potential future burdens on the FSLIC. There is challenge enough in marshalling the funds needed to pay for the merging or closing of institutions which are already insolvent. A funding proposal for that purpose is presented later in this report. It does not make sense to add to that burden soundly managed institutions which are temporarily unable to maintain the regulatory standards of good health because of regional or other factors beyond their control.

In promulgating the commercial bank forbearance rules, regulatory officials argued in 1986 that allowing extra workout time for institutions affected by downturns in the farm and energy sectors of the economy would pay off for everyone because these problems are temporary. Given enough time, these officials reasoned, the assets then performing poorly would recover their value at some point within a few years. Writing off those loans and foreclosing on the farmers and oil and gas producers now could conversely result in vast and unnecessary losses for the banks and their insurance agency as well as for borrowers. This reasoning is as valid now as it was then.

Moreover, the commercial banks addressed in the federal regulators' forbearance policy typically hold as collateral for their loans the farmers' harvests or oil and gas produced or equipment used by the borrowing firms. These commodities can fluctuate widely in value, depending on weather conditions, world markets and other factors difficult to predict.

On the other hand, loan portfolios of savings institutions are typically secured by land and houses. If real estate markets turn down, the value of the loan collateral can drop off -- in some cases, substantially. But some marketable value will always remain. And, given time, the value will likely swing back to or beyond its former level.

If there is a public policy justification for stretching out to seven years the time available to prudently managed commercial banks to work through less-plagued portfolios of farm and oil and gas loans, it stands to reason that the case for extending a time-buying option to residential mortgage lenders is all the more compelling.

As noted previously, in 14 states, the savings institutions posted losses, on the average, in the first half of 1986. The asset classification regulation makes these difficulties even more severe. The combination of this regulation and a depressed local economy means that the regulators can, in effect, force almost any institution located in an area undergoing economic difficulties into insolvency.

One has to question whether placing otherwise soundly and conservatively run institutions in this situation is in the long-term interest of anyone, including the FSLIC insurance fund -- particularly when the insurance fund is limited in the amount of problem cases it can handle in any given time.

Therefore, as well as developing a funding strategy for the FSLIC, the U.S. League is recommending measures to allow institutions in troubled economic areas the opportunity to work through their problems. This plan is larger than just a financial solution for the FSLIC. It combines FSLIC funding measures with a work-out program to preserve as many honestly run institutions in troubled sections of the country as possible.

Specifically the League recommends the following:

RECOMMENDATION #1:

The Federal Home Loan Bank Board should issue a policy statement to the Principal Supervisory Agents (PSAs) directing them to exercise forbearance from net worth requirements in handling well-managed institutions that find themselves in trouble due to local economic conditions.

In judging if an institution is well-managed, the PSA should determine whether or not
In judging if an institution is well managed, the PSA should determine whether or not
excessive growth or other irresponsible actions on the part of the institution's management, ownership or board of directors.

The forbearance policy statement should mirror the joint policy statement issued by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

The policy statement should direct the PSAs to consult with state savings institution commissioners in granting forbearance. Involving the PSAs and the state commissioners is completely consistent with the Bank Board's moving its examination personnel from Washington to the twelve regional Federal Home Loan Banks since such delegated handling of the problem can be much more affective than a centralized system from Washington.

The policy statement would allow the PSA to lower the capital requirement for specific institutions. One way to structure such a program is that the PSA would declare a specific area to be economically depressed. Institutions holding investments in those areas which they were required to write down could apply for a capital requirement reduction. If an amount of the loss reserve that was required was judged to be a result of depressed local economic conditions, that identified amount would be subtracted from the institution's required capital level.

The benefit of such a program is that it would allow some leeway for financial difficulties due to causes outside management's control while maintaining the regulator's ability to judge the condition of an institution. The Comptroller of tha Currency also pointed out this advantage to its forbearance program:

> "...the policy retains existing financial presentation and creates no inconsistencies with generally accepted accounting principles. The OCC believes that maintaining the integrity of financial statements is vital to assuring confidence in the banking system." [Federal Register, Vol. 51, No. 78, p. 15307]

RECOMMENDATION #2:

Consistent with the commercial bank regulators' joint statement, the Federal Home Loan Bank Board should require savings institutions to account for problem assets according to GAAP.

To facilitate this recommendation, the Bank Board should revise a number of its regulations:

* The asset classification regulation should use valuation standards consistent with GAAP in establishing the carrying value of assets.

* Appraisal Memorandum R41c should be rescinded immediately and its predecessor, Memorandum R41b, should be accepted instead as an interim measure pending study of an appraisal standard for the business. As Memorandum R41b is used to determine asset carrying values for existing assets in the interim, the Bank Board should use a discounting technique which is consistent with GAAP.

* Confine its use of the scheduled item approach to single family and two- to four-family residential mortgages since it is superflous for application to assets subject to the asset classification regulation. Also, the residual value after any write-down of income producing repossessed one- to four-family properties would not be subject to the additional 20 percent capital requirenment.

In the accounting area of most immediate and important concern to savings institutions today -- the accounting for problem loans and other problem assets -- regulatory accounting procedures call for far more rigorous treatment than does GAAP. Indeed, many savings institution managers have noted that, in the accounting sphere, they are facing the worst of all possible worlds.

Where regulatory accounting practices are more lenient than GAAP, public auditors apply GAAP standards. But where regulatory accounting procedures are tougher than GAAP, as in the problem asset area, public auditors and professional appraisers adopt the regulatory practices because they fear lawsuits by the FSLIC should the institution wind up as an FSLIC problem case. And in spite of all of this, the business is accused by the media and by politicians of lax accounting practices.

Under GAAP, a loan receivable is carried at the lesser of cost or 1) net realizable value, or 2) a carrying value determined in accordance with the provisions of SFAS 15 relating to troubled debt restructuring where the property is original obligor remains in place. The difference between these GAAP valuation methods and that required under regulatory accounting practices are outlined in detail in Appendix B.

The valuing on the basis of net realizable value results in the institution discounting future net cash flows from the sales and net revenues associated with the property at the institution's cost of money. Since the institution's cost of funds will almost always be lower than the discount rate used by an appraiser in appraising a property on the basis of R41c, the asset's regulatory carrying value will be reduced to a level below the carrying value required under generally accepted accounting principles.

As the detailed example on pages 34 and 35 in Appendix B clearly shows, the net effect over the term of the loan of each of the accounting methods is the same. What is eliminated in the methods allowed under GAAP is the upfront hit to income and net worth which occurs under regulatory accounting requirements. Under GAAP, the loss is spread more evenly and the institution's books reflect asset carrying values in a manner consistent with the practice at commercial banks and other business organizations.

The example also shows how the continuation of regulatory asset valuation techniques can significantly exacerbate the short term deterioration of the FSLIC by overstating losses when problems are recognized. Later, when the asset is sold and the debt repaid, perhaps too late for the institution involved, the FSLIC will record a gain which will bolster its reserves.

The third part of the recommendation asks that the Bank Board confine its use of the scheduled item approach to single family and two- to four-family residential mortgages since it is superflous for application to assets subject to the asset classification regulation.

Until the adoption of the classification of assets regulation in January 1986, the Bank Board had used the so-called scheduled items system to assess risk in an institution's lending portfolio. Loans in a delinquent status were included as scheduled items and each institution was required to increase its net worth by 20 percent of such items.

With the lending powers of savings institutions becoming more diverse, the Bank Board judged the scheduled items approach to be no longer adequate for assessing the risk of loans other than those on one- to four-family properties. One of the reasons for the inadequacy of the old approach was that it relied on timeliness of payments as a barometer of loan quality. However, many acquisition, development and construction loans, for example, were often characterized by having an interest reserve which prevented the loan from reaching delinquent status for, perhaps, a prolonged period of time.

Instead of a scheduled items approach, the Bank Board adopted the classification of assets system for such loans. This regulation provides for the classification of certain problem loans as substandard, doubtful or loss.

An institution is required to recognize a loss and to establish specific reserves against assets classified as loss or doubtful. The required reserves are 100 percent of the loan amount for a loss classification and 50 percent (later clarified to be a variable reserve of between 1 percent and 50 percent) for a doubtful classification. An asset classified substandard will be treated just as scheduled items have been treated in the past, requiring an increase in net worth of 20 percent of the substandard item.

The problem arises where the classification of assets regulation and a scheduled item approach are both applied to the same asset. For instance, suppose that an asset was judged to fall in the doubtful category and the institution was required to book a 50 percent loss and to post a 50 percent specific reserve. The remaining 50 percent is presumably recoverable but could still be judged to be a scheduled item requiring an additional increase in net worth of 20 percent of this recoverable amount.

Applying the scheduled item approach only to one- to four-family loans and using only the classification of assets approach for more non-traditional lending would eliminate this double hit. Doing so would make sense since the Bank Board itself judged thet the scheduled item approach was no longer appropriate for the latter form of lending.

In proposing this program, the League in no way encourages any slackening in the vigilance of the regulatory authorities to ensure that high-flying institutions do not expose the FSLIC to more risk of loss. It is enough of a burden to ask savings institutions to provide resources for the FSLIC to handle its existing caseload without being also asked to pay for new problems that could be avoided through effective supervision.

II: A FUNDING PROPOSAL FOR THE FSLIC

Over the last year and more, there have been dire predictions about the financial condition of the FSLIC. Commentators have suggested that the fund would be down to $1 billion in usable resources by the end of 1986. The reality is less grim. True, reserves declined by $3.9 billion, from $7.5 billion at the end of fiscal 1985 to $3.6 billion at the end of fiscal 1986. However, as Exhibit 6 shows, the FSLIC had cash and government securities on hand of $4.6 billion at the end of September, 1986. During fiscal 1986, this figure declined by $1.1 billion. Because the FSLIC had income of $2.4 billion, this means it expended $3.5 billion during the fiscal year.

During the same fiscal year, the insurance fund showed an operating loss of $3.9 billion. But this was more than explained by $5.9 billion in accounting loss provisions.

Nonetheless, given the problems facing the FSLIC, the U.S. League concedes that additional resources should be provided for the fund. Last year, the League developed a plan to provide the FSLIC with the funds to handle its problems. This plan would make the same resources available to the FSLIC for problem resolution over the next eight years as provided in the recapitalization proposal developed by the U.S. Treasury and the Federal Home Loan Bank Board. The main difference in the two plans was one of timing.

The major benefit of the League's preposal was that it would eliminate the need to borrow tha $10 to $15 billion envisioned in the Treasury/Bank Board proposal. These borrowings would have burdened the business with huge interest payments for up to 20 or more years. In the U.S. League's alternative, the funds needed would be collected on a pay-as-you-go basis while still allowing the FSLIC to resolve cases in far greater volume than it has in the past.

The borrowing approach of the Administration proposal was of concern to others besides the savings institution business. The Congressional Budget Office placed a major roadblock in the preposal's way when it ruled last July that the borrowings could not be scored as receipts by the government for budget purposes and, as a result, spending the proceeds in resolving cases would add to the federal budget deficit.

Technical changes in the proposal resulted in a change of position by the CBO. However, the CBO labeled its acceptance of the revised plan as "technical" and a "close call". The Chairman of the House Banking Committee called the plan "all smoke and mirrors".

In spite of the CBO's reluctant change of heart, tho plan was by its nature one of deficit spending. Federal budget deficits have been a cancer on the American economy for the last decade. The philosophy has been one of spend now and pay later. Similarly, the Treasury/Bank Board plan called for pushing the cost of current case resolution into the future, even into the next generation.

Over the last several years, the U.S. League's highest political objective has been to persuade the Congress and tho Administration to get the federal budget deficit under control. It should be no surprise that the League feels uncomfortable about the borrowings in the Administration proposal, and would advance a "pay-as-you-go" approach instead.

In its proposal, the savings institution business took a unique step. It did not seek the appropriation of taxpayer money to solve its problems. Instead, it agreed to use the to provide resources for the FSLIC to handle its existing caseload without being also asked a hand in creating.

There were two main criticisms of the League's pay-as-you-go approach. First, critics charged that the proposal did not provide enough resources to the FSLIC in the early years to handle its most immediate problems. It was asserted that it would be more expensive in the long run not to provide the FSLIC with huge amounts of funds up front since problem cases would continue to fester and become more expensive to resolve if they were not conclusively dealt with in an expeditions fashion. This contention is dealt with in Appendix D.

Second, it was charged that if the FSLIC's problems proved larger than expected, there was no way in which even more funds could be provided.

In an attempt to answer these criticisms, the U.S. League has re-examined its position to see if there is any way to meld its prior proposal with that of the Treasury/Bank Board to develop a solution for the funding needs of the FSLIC that all parties would accept.

The result is a furing of the "pay-as-you-go" approach with a modest bonding approach. To accurately reflect who is footing tha bill in this plan, as indeed in tha other plans, we have called this the "Savings Institution Self-Help Plan for Funding the FSLIC."

In particular, the Task Force proposed tha following three recommendations as a legislative program for funding the FSLIC:

Recommendation #1:

A three-part program for providing resources to the FSLIC that substantially meets the funding objectives of the plan advocated by the Treasury/Bank Board plan. This program is outlined in detail later in the report.

Recommendation #2:

Restore the legal framework governing the FSLIC's secondary reserve to its condition prior to the Garn St Germain act of 1982.

The Garn-St. Germain act included language in Section 126 permitting the secondary reserve to be used on the same basis as the primary reserve. Previously, the secondary reserve was to be tapped only to cover FSLIC losses and was to be used only to the extent other funds were unavailable -- restrictions flowing from tha fact that the funds in tha secondary reserve represent prepaid insurance premiums that were intended to be refunded over time.

These restrictions are needed to help convince the accounting profession that savings institutions should continue to carry their investment in the secondary reserve as an asset on their books. While the 1982 changes were justified under extreme conditions then existing, there is no need for their continuation in the context of the additional funds being provided to the FSLIC by the funding program.

Recommendation #3:

Extend the provisions of Section 597 and Section 368(a)(3)(D)(ii) of the tax code beyond their expiration date of January 1, 1989.

In dealing with the caseload of the FSLIC on the schedule common to both the Treasury/Bank Board and the U.S. League versions of an FSLIC recapitalization plan, it is important to recognize the necessity of retaining two provisions, enacted in 1981 as part of the tax code changes at that time, which reduce hard dollar FSLIC outlays in problem resolutions.

These tax code provisions are Section 597 and Section 368(a)(3)(D)(ii). The first extends tax-free status to FSLIC dollars expended to resolve a problem case and the second permits an acquirer of a problem case to use the shelter of the net operating loss carryforwards of the acquired institution. In the recently adopted revisions of the tax code, these two provisions were extended until January 1, 1989, but it is essential to extend them for at least a further three years, as originally recommended by the Treasury
extend th m further three years,9 s origina y ommended by th T asuryble to
the FSLIC can be used to maximum effect in case resolutions.

SAVINGS INSTITUTION SELF-HELP PROGRAM
FOR FUNDING THE FSLIC

The Task Force recommends the following three part program for funding the FSLIC:

Step 1:

The business would continue, if needed, to pay the special insurance assessment, which was first levied at the beginning of 1985, on the following six-year phase-down schedule:

1987	100.00%
1988	83.33%
1989	66.67%
1990	50.00%
1991	33.33%
1992	16.67%
1993 & Thereafter	0.00%

This would provide the FSLIC with the following funds from the special assessment (assuming that the business' deposits continued to grow at their estimated 1986 rate of 6 percent per year):

1987	$1.2 Billion
1988	$1.0 Billion
1989	$0.9 Billion
1990	$0.7 Billion
1991	$0.5 Billion
1992	$0.3 Billion
Total	$4.6 Billion

Combined with the FSLIC's regular premium income, this would provide the FSLIC with the following premium income over the next ten years:

1987	$2.0 Billion
1988	$1.9 Billion
1989	$1.8 Billion
1990	$1.6 Billion
1991	$1.5 Billion
1992	$1.3 Billion
1993	$1.1 Billion
1994	$1.2 Billion
1995	$1.3 Billion
1996	$1.3 Billion
Total	$15.0 Billion

The U.S. League strongly believes it is vital for savings institutions to see some end to the special insurance assessment. A savings institution with the same structure as a competitor commercial bank pays at least two end one-half times as much in insurance premiums because of the special premium.

The inequities become even more pronounced when one looks at the insurance burden on and derived insurance benefit for large commercial banks. These banks have less of their liability structure made up of domestic deposits than the typical savings institution. This means they are assessed insurance premiums on a smaller base when expressed as a percentage of their total assets. On the other hand, as shown by the case of Continental Illinois end as has been basically admitted by bank regulatory authorities, there is probably de facto insurance of 100 percent of liabilities of the largest commercial banks because they are too big to be allowed to fail.

Thus, the typical savings institution faces two inequities in deposit insurance as compared to a large commercial bank:

* The premium rate is at least two and one-half times as large;

* The higher premium buys less insurance.

The problem with such a system, in addition to the obvious one of inequitable treatment, is that it encourages stronger savings institutions to migrate from the FSLIC-insurance system to that of tha FDIC unless they can, at least, see an end to the special assessment.

This is one of the factors that most troubled the U.S. League about the bonding approach in the Treasury/Bank Board plan. Carrying costs of the debt would be so high and consume such a large amount of the income from the FSLIC's regular premium that it seemed likely there would not be an end to the special assessment in the foreseeable future. This would encourage strong institutions to leave the system, compounding the FSLIC's difficulties and probably leaving it with insufficient resources to resolve its problems.

Step 2:

A funding corporation would be set up which would, if needed, issue zero-coupon bonds which would be repaid from the dedication for that purpose of the 20 percent of net income that the Federal Home Loan Bank System currently sets aside in the so-called legal reserve and which is not available to pay dividends to member institutions.

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The funding corporation would have the authority, if the cash resources of the FSLIC fell below some specific level, to raise up to $2.5 billion in such borrowings in the first year of the program and another $2.5 billion in the second year.

Appendix E outlines in detail how such a system would work. The appendix also points out that if the Bank System's earnings do not grow quickly enough, it is possible that the 20 percent of net income dedication might not be sufficient to retire the principal and accrued interest on the bonds. In that case, the difference would be made up by assessments on the business for the shortfall. In any year in which the business had to pay a special assessment, any required payment to the funding corporation to make up a Bank System deficiency in servicing the debt would represent a first call on the special assessment -- in other words, the payment to the funding corporation and the special assessment would never exceed one-eight of one percent of deposits, the statutory limit on the special assessment.

Step 2:

With the savings institution business being potentially asked to contribute huge amounts of resources to the FSLIC, the Bank Board should be accountable for their use by the insurance fund. Therefore, an oversight committee with representatives from the business would be statutorally established, the Bank Board would be required to report busin ss be statutorally e tablish , th Bank Bo c quired report funds via the funding corporation would be subject to annual Congressional scrutiny.

Taken together, the steps in the savings institutions self-help program are schematically outlined in Exhibit 7.

RESOURCES FOR THE FSLIC UNDER THE INDUSTRY SELF-HELP PROGRAM

The following table gives the total external resources available to the FSLIC over different timeframes for the savings institution self-help program as compared to the Treasury/Bank Board proposal where it was contemplated raising $10 billion to $15 billion in borrowings over a four- to five-year period:

FSLIC CASH FLOW FROM EXTERNAL SOURCES UNDER INDUSTRY SELF-HELP PROGRAM AND TREASURY/BANK BOARD PLAN

Cash Flow Over:	U.S. League Savings Insts. Self-Help Program	Treasury/Bank Board Program: $10 Billion in Borrowings	Treasury/Bank Board Program: $15 Billion In Borrowings
2 Years	$ 8.9 Billion	$ 8.7 Billion	$ 9.6 Billion
5 Years	$13.8 Billion	$16.8 Billion	$21.4 Billion
10 Years	$20.0 Billion	$19.0 Billion	$21.6 Billion
20 Years	$38.7 Billion	$29.7 Billion	$28.3 Billion

In other words, over the short-term (1987 and 1988), the industry self-help program would provide slightly more resources to the FSLIC than the Treasury/Bank Board plan. It would also provide significantly more over the long term since the FSLIC would not burdened with paying the interest on $10 billion to $15 billion in borrowings. Only when measured over a five-year horizon does the plan provide less than the Administration plan.

ADVANTAGES OF THE SAVINGS INSTITUTIONS SELF-HELP PROGRAM

1. One criticism leveled at the League's pay-as-you-go proposal was that it did not provide enough money in the short run for the FSLIC to solve its most pressing problems. However, the preceding figures show that the new self-help program could provide the FSLIC with external capital of $8.9 billion over the next two years, $200 million more than in the Treasury/Bank Board proposal if that proposal envisioned raising $10 billion in borrowings. Even if $15 billion in borrowings were raised under the Administration program, only $700 million more would be provided to the FSLIC over the first two years than in the League's plan.

In addition to these external resources, the FSLIC has its annual investment income and should soon see an inflow of cash from the disposition work of the Federal Asset Disposition Association and other workout efforts.

Thus, over the next two years, the FSLIC should have an inflow of funds of $10 billion or more, or an average of $5 billion per year -- $1.5 billion more in expenditures than the record level in fiscal 1986.

If the FSLIC were actually to spend more than $5 billion per year disposing of problem assets -- as against setting up accounting reserves for future problem resolution -- there is a real possibility it would be merely exacerbating its own problems, those of surviving savings institutions and of local economies in general. This is particularly true because the bulk of the FSLIC's problem assets are located in just a few states, and this activity would have a serious depressant impact on these economies.

Additionally, observers doubt that the FSLIC can spend more than $5 billion per year efficiently, particularly since it has had problems in attracting full-time personnel to staff its top positions. Also it must be remembered that until 1983, the FSLIC handled most of its problems through mergers. As a result, the FSLIC could traditionally operate with a small staff because it did not have a big liquidation operation. As compared to the FDIC, with more than 5,000 employees working on bank failures, the FSLIC received a tremendous assist from the industry through the merger process.

As a result, the FSLIC did not begin to face numerous or serious liquidation problems until 1984, when problem cases arising from negative interest rate spreads began to be overshadowed by cases typified by bad assets.

In response, the Bank Board and the FSLIC showed considerable ingenuity in designing innovative ways to handle the new situation. In particular, they initiated the MCP program and set up the Federal Asset Disposition Association to gain control of problem institutions and to convert non-earning assets to earning assets.

Nonetheless, like any business or government organization that faces rapid growth and a radical change in its operating environment, the FSLIC should be reorganized and updated. When an entity grows very rapidly, it is difficult to manage the growth, as typified by the problems at those savings institutions that grew rapidly.

The Bank Board has a task force working on a reorganization plan for the FSLIC. This is commendable and the U.S. League will support that effort. Meanwhile, however, it does not make sense to turn over large sums of money to an organization that does not appear, at this time, to be capable of handling and spending such sums efficiently.

In addition to the added resources the program provides the FSLIC, the agency also has available its own cash resources -- $4.6 billion at the end of September 1986. It is true that this figure is higher than the official reserves of the insurance fund. That is because some of its cash resources serve as backing for loss contingencies for the future -- particularly, the general loss contingency of $1.6 billion that was set up at the end of 1985. In an accounting sense, however, this is merely taking funds from one general reserve -- the insurance reserve -- into another general reserve -- the contingency for future losses.

Thus, over the next 10 years, the FSLIC will have up to $30 billion for use in case resolutions from external cash flow, investment income, asset disposition and from its initial resources, including those set aside as reserves for future losses.

2. Another criticism leveled at the League's pay-as-you-go proposal was that it lacked flexibility to provide even more funds for the FSLIC if its problems require them. The Treasury pointed out that, if necessary, its program could raise $15 billion or more instead of $10 billion threugh borrowings in capital markets. (Already concerned about the implications of borrowing $10 billion, savings institutions were not reassured that the borrowing exposure could rise to $15 billion or more.)

   <u>The League's revised program conserves flexibility. It does not consider touching the $2.2 billion currently held in retained earnings in the Federal Home Loan Bank System</u>. If the $5 billion in borrowings that the League's program could raise over the next two years prove insufficient, Congress would have the option of using the $2.2 billion in retained earnings as backing for further borrowings along the lines of the Treasury/Bank Board program.

   Furthermore, if the $10 billion or more provided to the FSLIC over the next two years is not sufficient for the fund's needs, then the League considers it appropriate that the Congress should revisit the issue rather than leave it administratively possible, without Congressional review, to continue burdening the system with further huge amounts of debt.

3. Over the next 20 years, the League's program is far cheaper than the Treasury/Bank Board proposal. When measured in present value terms, the cost of the special assessments and debt service under the League's alternative is far less than that of the Administration's -- $9.6 billion compared with $15.5 billion.

4. Over the next 20 years, the League's proposal could have the Bank System contribute $14.9 billion (with a current value of $5.8 billion) to retire the debt. The Treasury/Bank Board plan would tap the Bank System for $3 billion. However, the latter would be over a much shorter period -- three to five years. Furthermore, the contribution of the $14.9 billion is contingent on the Bank System being able to afford it. If the Bank System's earnings do not grow over the twenty-year period, its contribution would be limited to $5.5 billion, with a present value of only $2.7 billion.

The Administration's proposal would tap the Bank System's retained earnings for $3 billion regardless of the System's profitability.

5. Since part of the FSLIC's income stream would not be used to pay interest on borrowings, the likelihood of being able to phase out the special assessment is increased. With the continuing debt service burden under the Administration plan, many observers believe the possibility of phasing down and eventually eliminating the special assessment is far more remote.

6. Because the service and repayment of the borrowings are coming from the Bank System and the business in the League's plan rather than representing a first call on FSLIC's income as in the Treasury/Bank Board plan, the League's proposal will not run into the same budget scoring problems from the Congressional Budget Office. With the Administration plan, the CBO gave only grudging approval last year and could change its position this year if it is again called upon for an opinion.

APPENDIX A: MODELS OF SUPERVISORY FORBEARANCE

The inflationary spiral of the 1970s and its cure in the 1980s have required that policy makers grapple with many dislocations in the economy. Huge amounts of taxpayer funds have been poured into the farming sector in an effort to preserve the nation's agricultural infrastructure. However, in an age of historically large federal budget deficits, most efforts to overcome economic dislocations have taken the form of time-buying stretchout strategies. These strategies provide models and precedents for helping well-managed savings institutions work out of problem situations whose cause is beyond those institutions' control.

In particular, three strategies adopted in the financial institution sector are relevant to the subject at hand:

A. Allowing savings institutions to work out of problems created by the high interest rate environment of the early 1980s;

B. The legislated accounting changes for the Farm Credit System, and

C. The forbearance guidelines adopted by the federal commercial bank regulators.

A. SAVINGS INSTITUTIONS' RECOVERY FROM EARLY-1980s DIFFICULTIES

In 1981-82, the vast majority of savings institutions suffered devastating operating losses as a result of a process of uneven deregulation coupled with interest rates at historically high levels. The carrying cost of newly-deregulated deposits soared while the return on mainly long-term fixed-rate assets remained relatively stagnant.

During these two years, FSLIC-insured savings institutions reported bottom-line losses of $8.9 billion, a staggering 26.7 percent of the aggregate net worth of the business at the end of 1980. Indeed, if the market value of their portfolios were computed at the height of the interest rate cycle, the vast majority of savings institutions would have been insolvent. Some observers predicted the end of the savings institution business.

Faced with a disaster of this magnitude, the only practical solution was to buy time and ride the crisis out. Congress adopted the Net Worth Certificate program, and the regulators allowed many institutions to operate below the minimum capital standards.

The results have been gratifying. In the first half of 1982, FSLIC-insured savings institutions had an annualized return on assets (ROA) of -0.82 percent. By the first half of 1986, the business had an ROA of +0.50 percent.

Even more remarkable is the turnaround in the business in some states. In the 1981-82 period, the business in the large "rust-belt" states experienced among the most pronounced difficulties. For instance, institutions in New York had an aggregate ROA of -1.51 percent, and in Illinois, of -1.0 percent. By the first half of 1986, institutions in New York posted an aggregate ROA of +1.18 percent and Illinois institutions an ROA of +1.12 percent. From being among the worst in the nation, in early 1986 institutions in these states turned in some of the best performances.

In a September 1986 report, the Government Accounting Office (GAO) maintained that the FSLIC "warehoused" at least 582 thrifts for some or all of the period 1982 to 1985. Allowing them the chance to work back to health was obviously beneficial to those institutions and the communities they serve. However, the GAO report bears eloquent testimony to the benefits to the FSLIC itself of taking a gradual approach to providing final solutions.

The time to dispose of institutions crippled by losses due to negative spreads was not at the peak of the interest rate cycle in 1981-82. By taking more of a wait-and-see attitude, the FSLIC saved itself billions of dollars. Specifically, the GAO found that, in examining 107 institutions that it claimed the FSLIC warehoused for all of the period between 1982 and 1985, the FSLIC realized:

> "...potential savings of approximately $3.0 billion due directly to delaying resolution of the thrifts' problems. However, because the FSLIC did not expend $5.3 billion in 1982, it neither depleted the insurance reserves nor borrowed (from the Treasury, for example). It was able to continue to earn interest on the fund's assets and avoid paying interest on any borrowings. In this way, it saved an additional $1.7 billion in interest over the three year period to December 1985. In total, we estimate that the FSLIC saved $4.7 billion by delaying resolution of 107 of the insolvent thrift cases in 1982." ["Cost to FSLIC of Delaying Action on Insolvent Savings Institutions", GAO, September 1986, p. 11]

It might be noted that the estimated $4.7 billion in savings almost precisely equals the $4.6 billion in cash and government securities the FSLIC had on hand at the end of September 1986. Were it not for the above savings, the FSLIC would now be totally out of resources.

As is evident from its title, the GAO study maintains that what worked in the past will not work in the future, i.e., that adopting a time-buying strategy for its current problems will cost rather than save the FSLIC money. This GAO contention is examined in detail Appendix D.

B. ACCOUNTING CHANGES FOR THE FARM CREDIT SYSTEM

In 1986, the Congress passed the Farm Credit Act Amendments, in which it legislated regulatory accounting provisions for the Farm Credit System (FCS) less than a year after it had mandated that the FCS keep its books in accordance with GAAP. The new legislation allowed the system to defer the recognition of certain excess costs and losses up to a period of 20 years. This was designed to allow the FCS to:

1. Delay the depletion of its capital;

2. Delay the need for a government bailout; and

3. **Offer its borrowers loans with lower interest rates and, thus, encourage stronger borrowers to remain within the system.**

As a dedicated lender to the troubled agricultural sector, the Farm Credit System has been devastated by losses, problem assets and stronger borrowers fleeing the system. In the 18 months from the beginning of 1985 through mid-1986, the FCS had losses of $3.8 billion and for the four-year period from 1985 through 1988 projected losses of $8.3 billion. By mid-1986, the system had nonaccrual and problem loans of about 20 percent of its portfolio.

The system has exposed itself to fluctuations in interest rates by funding variable rate loans with long-term fixed-rate bonds. As a result, it is doubly hit by a decline in inflation and interest rates. The FCS has an overhang of long-term, high-cost liabilities acquired in the early 1980s. Because of this the FCS has had to charge above-market rates on its loans. This has caused borrowers with other funding sources to flee the system. Moreover, such borrowers fear the loss of the FCS stock they are required to buy in order to borrow from the system. The result is a classic adverse selection problem evidenced in a rapid declining portfolio of loans outstanding (falling from $85 billion at the end of 1983 to $61.5 billion in June 1986), a decline in capital stock and a remaining customer base of weak borrowers.

To buy time for the system, the Farm Credit Act Amendments of 1986 legislated accounting changes for the FCS. Subject to prior approval from their regulator, the Farm Credit Administration, the Farm Credit banks can capitalize and write off over a period of up to 20 years:

1. The difference between the average interest rate on obligations incurred before January 1, 1985, and the rate on new obligations at the time of the passage of the legislation. The conference report estimated the difference to be 4.4 percent (10.6 percent on old obligations versus 6 percent on current ones). The effect is that the 4.6 percent annual excess cost on about $30 billion of obligations can be expensed over twenty years rather than over the 3-1/2 year average remaining life of the obligations.

2. The amount by which the banks' actual loan losses and provision for loan losses during 1986 through 1988 exceed one-half of one percent of the loan portfolio (the level of provision for losses "ordinarily" maintained by the system).

In both House and Senate deliberations on this legislation, an interesting letter was read into the record that evidenced a pragmatic Wall Street view of the proceedings. The letter from the investment firm of Rothschild, Unterberg, Towbin, Inc., stated in part:

> "We are less concerned with the accounting treatment of FCS losses under the new act than the reality of the problems the FCS currently faces...

> The time when the FCS might ultimately require federal financial assistance will be postponed, and the additional breathing space the act provides improves the FCS chances of surviving independently. Since the FCS can fund the losses with cash raised in the capital markets, this solution is workable, and the ends certainly justify the means." [Congressional Record, October 17, 1986, pp. H 11458 and S 16945]

C. FORBEARANCE GUIDELINES FOR COMMERCIAL BANKS

Federal policy makers are faced with two serious dilemmas as they try to handle the unprecedented and still-growing number of weakened financial institutions. First, the deposit insurance funds are not equipped -- indeed, were not designed -- to close the books and liquidate a substantial amount of assets in the financial system in a short period. The funds were conceived more as a social insurance program to guarantee depositors a safe and reliable financial system than as a large repository of cash reserves ready to be expended at one time. Even to the extent that they resemble the operation of a private insurance company, they could not be expected to finance in a single year or several years the closing or recapitalizing of so many weakened institutions.

The second dilemma supervisors face is that while the economy and the financial sector generally have been enjoying a prolonged recovery, some industries concentrated in several regions of the country have been left behind. Consequently, a few hundred savings institutions and many hundreds of commercial banks that have been operated carefully and conservatively have gotten into trouble and in some cases are approaching insolvency. Their difficulties are typically caused by economic conditions beyond their control.

Recognizing these dilemmas, the three federal commercial bank regulatory agencies (the Federal Reserve Board, the Federal Deposit insurance Corporation and the Comptroller of the Currency) in a March 11, 1986 joint policy statement outlined a program of supervisory forbearance toward soundly managed banks heavily dependent on agriculture or the oil and gas industries.

In its implementing policy statement, the Comptroller of the Currency characterized the program as:

> "...supervisory policies that will support basically sound, well-managed banks in weathering what is expected to be a difficult but transitional period." [Federal Register, Vol. 51, No. 78, p. 15305]

The "difficult but transitional period" that prompted the regulators to move to this approach resulted from the economic dislocations discussed in an earlier section of this report. The program is to remain in effect for seven years from its inception in early 1986. For at least that period, the regulatory agencies were jointly acknowledging business-as-usual treatment of institutions tied to the distressed sectors of the economy does not make any sense. The Comptroller further explained:

> "Problems in the agricultural economy have directly affected the banks that provide financing for the agricultural sector. Severe financial prossures on borrowers dependent on the agricultural economy have resulted in an increase in loan delinquencies. As conditions have worsened, borrowers increasingly fear foreclosure, while bankers are increasingly concerned about supervisory actions that may result from reduction in their banks' capital as a consequence of loan losses." [op.cit. pp. 15305-15306]

The Comptroller's statement included these elements in the implementation of the forbearance program:

> 1. "...encouraging banks to work with their troubled agricultural and oil and gas borrowers..."
>
> 2. "...establishing a capital forbearance policy..."
>
> 3. "...encouraging the use of generally accepted accounting principles which may permit loan restructurings without loss recognition..."
>
> 4. "...relaxing lending limits." [op.cit. p. 15305]

The OCC and other regulatory agencies made it clear that poorly managed banks would not be able to take advantage of the forbearance measures. Examiners and supervisors retain authority to enforce sound banking operating standards. In outlining the capital forbearance portion of the program, for example, the OCC statement said:

> "The OCC reserves the right to terminate capital forbearance for banks ongaged in unsafe or unsound or other objectionable practices, or if it becomes apparent to the OCC that the bank is unwilling or unable to comply with an acceptable capital plan." [op.cit. pp. 15306-15307]

Recognizing the segmented economy and pockets of depression, the bank regulators had earlier indicated their desire to avoid closing well-managed farm banks or unduly pressuring hard-hit agricultural borrowers by the supervisory actions taken against such banks. A joint statement in April, 1985, for example, reminded banks that the federal regulators wanted them where possible to:

> "...enter into work-out plans with agricultural borrowers who are experiencing temporary difficulties in meeting their debt service obligations." [op.cit. p. 15306]

The new joint statement renewed that encouragement with respect to farmers and extended the same attitude to oil and gas borrowers.

The capital forbearance element of the program, the Comptroller noted,

> "...formally acknowledges that capital should be used during periods of unusually heavy loan losses and that capital replenishment takes time." [op.cit. p. 15306]

The statement specified that the OCC "...will not take administrative action to enforce the minimum capital requirements..." in cases where the bank is an agricultural or oil and gas lender and its weakened capital position results from problems in these sectors of the economy. To qualify, the bank must satisfy the OCC that it is well-managed and that it has a workable plan to restore its capital to required levels by 1993. Applications for capital forbearance are automatically granted if the Comptroller's office does not respond within 60 days. Specifically:

> "Under the capital forbearance policy, the OCC will not take administrative action to enforce the minimum capital requirements ... against a bank whose primary capital ratio declines below 5-1/2 percent to no less than 4 percent before December 31, 1987" [op.cit. p. 15306]

provided that the bank meet certain requirements.

Further:

> "Upon written request of an agricultural/oil and gas bank and at the discretion of the OCC, the capital forbearance policy may be extended, in special circumstances, to a bank with a primary capital ratio lower than 4 percent." [op.cit. p. 15306]

The regulators' repeated encouragement over the past several years that banks enter into "work-out" agreements with troubled farm sector borrowers and the flexibility of the capital forbearance portion of the program were both made possible to some extent by another key element of the forbearance program: Permission for the affected banks to continue carrying slow paying or non-paying loans without recognizing them on their books as losses.

This seeming loophole in commercial bank regulatory discipline occurs because of the application of an accounting rule adopted in 1977 as part of GAAP by the Financial Accounting Standards Board.

The rule, known as Statement of Financial Accounting Standards No. 15 (SFAS 15), was written in essence to allow commercial banks to work their way out of weak or non-performing loans that remained on their books following the mid-1970s collapse of real estate investment trusts and the loan default by New York City. In effect, forbearance was written into the formal accounting rules.

In their forbearance program, the bank regulatory agencies advised farm and energy banks to consider using this restructuring technique to avoid a loan loss rather than taking "more precipitous action such as foreclosure." Use of SFAS 15 is justified where economic conditions have led to problem loans, the Comptroller's statement reasonod. It noted thet the "downturns" were confined to certain parts of the economy and were expected to be short-lived. The Comptroller's statement described its position this way:

> "Although OCC examiners will point out to management the weaknesses that may be present in loans, the OCC does not require foreclosure on collateral or the acceleration of the maturity of loans. The OCC recognizes that downturns in certain sectors of the economy are expected to be transitory. Therefore, lenders may find that the most prudent policy is to restructure the loan terms rather than to take more precipitous action such as foreclosure." [op.cit. p. 15306]

The practical effect of this accounting rule that allows banks to avoid recognition of certain loan losses was outlined by the OCC as follows:

> "This standard allows a loan to continue to be carried on the bank's books without any loss recognition if the loan is formally restructured in a manner so that it is probable and estimable that the borrower can repay the loan under the new terms, and that the total future cash payments by the borrower (principal and interest combined) at least equals the loan amount on the bank's books." [op.cit. p. 15307]

In other words, while a substantial portion of any non-paying loan would normally have to be "written off" or deducted from a bank's income and capital as soon as it becomes apparent that it will not be repaid or that the borrower cannot meet the interest payments, a loan categorized as a restructured troubled debt can continue to be counted as a good asset -- even if no interest payment under the original terms of the loan is ever paid. The Comptroller's statement continued:

> "Accordingly, a bank which reasonably expects a borrower's future cash payments to equal or exceed the loan amount does not need to recognize a loss on the restructuring. In those situations where it is expected that the future cash payments on the restructured loan will be less than the loan amount, the loss recognized is limited to the expected cash flow deficiency." [op.cit. p. 15307] [emphasis supplied in OCC text]

Reporting and disclosure requirements for restructured loans were modified so they would not have to be reported as nonperforming assets if they perform according to the new loan terms. These loans would be reported instead as loans "restructured and in compliance with modified terms."

The bank regulators also adopted a relaxation of lending limits for banks whose capital is impaired and as a result would normally have to curtail the amount of their lending to a single borrower. The OCC explained:

> "...the declines in capital attributable to the problems in the oil and gas and agricultural sectors of the economy may cause some banks to be unable to serve the normal credit needs of a greater number of their creditworthy customers. In order to reduce the impact of those loan losses on a bank's ability to meet the legitimate credit needs of its financially sound customers, the OCC believes it necessary and appropriate to relax lending limits during the period in which the capital forbearance policy is in effect [i.e., through 1992]." [op.cit. p. 15307]

While the bank regulators' program may not offer a precise model for savings institution supervision, it contains a number of principles which are readily applicable:

* It is a time-buying strategy for well-managed institutions which happen to serve the needs of communities and industries severely affected by economic depression.

* It recognizes the value of preserving sound institutions at the relatively minimal cost of relaxing the rules temporarily.

* It endorses the concept of counting nonperforming debt assets at full value if there is a realistic prospect that the borrowers will pay them back after working their way through an economic downturn.

* It maintains the integrity of the supervisory process, keeping intact the power of supervisors to step in where unsafe and unsound practices are discovered, even where an institution is among those otherwise entitled to forbearance.

APPENDIX B: ACCOUNTING FOR PROBLEM LOANS: GAAP vs. RAP ACCOUNTING PRACTICES

Currently, there are significant differences in the methods of accounting for problem assets on a generally accepted accounting principles basis and the basis of accounting which may be prescribed under regulatory accounting practices. Under regulatory accounting practices, the regulators have authority to require a savings institution to obtain an appraisal for a property securing a loan, and adjust the loan carrying value to the appraised value of the collateral property if the appraised value is less than the association's loan balance.

The regulatory rules require that such appraisal be performed under the guidelines of Memorandum R41c. R41c requires the appraiser to discount the property's expected sales price at a rate which, in almost all cases, will exceed the institution's cost of money. This discount rate is intended to compensate a current purchaser of a property for 1) interest cost of carry, 2) risk, and 3) profit. This "deep discounting" typically results in the R41c appraised value of a property being significantly lower than the net carrying value of a problem loan valued on the basis of generally accepted accounting principles.

Under generally accepted accounting principles, a loan receivable is carried at the lesser of cost or 1) net realizable value, or 2) a carrying value determined in accordance with the provisions of SFAS 15 relating to troubled debt restructuring where the original obligor remains in place.

The valuation on the basis of net realizable value results in the institution discounting future net cash flows from the sales and net revenues associated with the property at the institution's cost of money. Since the institution's cost of money rate will almost always be lower than the discount rate used by an appraiser in appraising a property on the basis of R41c, the asset's regulatory carrying value will be reduced to a level below the carrying value required under generally accepted accounting principles.

In a troubled debt restructuring in accordance with SFAS 15 where the original borrower remains in place and the terms of the receivable are modified only as to interest rate and/or term, a discount rate as low as 0 percent may be used in establishing the carrying value of the related loan. The use of this lower interest rate, then, results in the carrying value of the asset being higher than the carrying value if the asset was valued on the net realizable value basis, and significantly higher than if valued on the basis of an R41c appraisal.

The Task Force believes the Bank Board should adopt generally accepted accounting principles for purposes of establishing reserves for loan losses. In cases where it is appropriate to determine the net realizable value under generally accepted accounting principles, the carrying value will be set at an amount more closely in line with the actual value to be received by the institution net of all costs (including interest costs) of carrying a property to its final disposal. This represents a far more accurate accounting for the asset than the accounting permitted under regulatory accounting principles, involving an R41c appraisal.

The use of an R41c appraisal under regulatory accounting results in larger than actual losses being recorded at the time a problem loan is identified and reserved for, with resulting profit pick-up at the time of sale in the future. This method unnecessarily penalizes the current period's operations and results in offsetting gains in future periods.

To illustrate the differences in the application of the three different accounting methods, consider the following example of a troubled loan. In this example, it is assumed that the appraiser and management agree upon the following assumptions:

Troubled Loan Balance	$10 million
Loaning Status	50% leased with substantial leasing concessions for the first two years.
Projected Net Operating Income:	
Year One	$ 0
Year Two	0
Year Three	400,000
Year Four	800,000
Year Five	1,000,000
Cost of Funds	7.5%
Discount Rate used by Appraiser	13.0%
Assumed Value of Collateral Building at the End of Five Year Period	$10 million
Out-of-Pocket Payments to be Made by Borrower (Secured by Letter of Credit)	$100,000 per year in years one through five.

Following is an exhibit demonstrating the impact of the three different accounting methods on the financial statements of an association over the remaining five year period of the loan.

	Year One	Year Two	Year Three	Year Four	Year Five	Total
Regulatory Income						
Loss on Write Down to Appraised Value	$(3,262,000)	0	0	0	0	$(3,262,000)
Investment Income	100,000	$100,000	$500,000	$900,000	$1,100,000	2,700,000
Gain on Disposition of Loan	0	0	0	0	3,262,000	3,262,000
Net Income Effect of Accounting Policy	$(3,162,000)	$100,000	$500,000	$900,000	$4,362,000	$2,700,000
GAAP Net Realizable Value						
Loss on Write Down of Loan	(1,012,000)	0	0	0	0	(1,012,000)
Investment Income	674,000	717,000	764,000	783,000	774,000	3,712,000
Gain on Disposition of Loan	0	0	0	0	0	0
Net Income Effect of Accounting Policy	(338,000)	717,000	764,000	783,000	774,000	2,700,000
FASB Troubled Debt Restructuring Accounting						
Loss on Restructure of Loan	0	0	0	0	0	0
Investment Income	512,000	533,000	555,000	558,000	542,000	2,700,000
Gain on Disposition of Loan	0	0	0	0	0	0
Net Income Effect of Accounting Policy	$512,000	$533,000	$555,000	$555,000	$542,000	$2,700,000

APPENDIX C: BACKGROUND ON RECAPITALIZATION

The drive to inject additional funds into the Federal Savings and Loan Insurance Corporation (FSLIC) started in 1985 with a proposal from Federal Home Loan Bank Board Chairman Edwin Gray to adopt a variation on the 1 percent capitalization of the National Credit Union Share Insurance Fund which had been completed a year earlier.

Existing law authorizes the Bank Board to require FSLIC-insured institutions to make deposits to the fund of up to 1 percent of their insured savings accounts. That provision had been incorporated in the FSLIC law at a time when the major fear for the insurance fund was a shortage of readily available cash -- a liquidity crisis -- which might jeopardize its ability to pay depositors of failed institutions. However, while a deposit from institutions would improve the fund's cash position, it would do nothing to strengthen its balance sheet. And the problem of the 1980s is a shortfall of equity -- a balance sheet problem -- rather than a lack of liquidity.

Recognizing this flaw in the 1 percent deposit authority, the Bank Board offered a plan to modify that authority. The amount contributed would be the same 1 percent of an institution's insured deposits, but instead of being a loan to the FSLIC, it would take the form of a capital investment for the FSLIC which the FSLIC could count as reserves.

It was envisioned that institutions could count the 1 percent contribution on their balance sheets as assets just as they could presumably count a 1 percent deposit. Accounting experts warned, however, that the "asset" to be carried by the institutions would be of doubtful collectibility and, hence, of doubtful value inasmuch as it would likely be destined for use in the resolving problem cases.

Meanwhile, the Bank Board moved on the regulatory, supervisory and other fronts with a number of steps aimed at containing problem cases and minimizing the eventual cost of their resolution. These included establishing the Federal Asset Disposition Association (FADA), a federally-chartered association set up to help realize the maximum return on defaulted properties and other assets held by insolvent institutions; initiation of the management consignment program (MCP) under which management teams borrowed from healthy institutions could be put in charge of troubled institutions sustaining large losses; moving the examination staff to the jurisdiction of the twelve regional Federal Home Loan Banks so they would be nearer to the institutions they were charged with examining and so their numbers and levels of expertise could be enhanced without the need to deal with federal pay and head count limitations; and creation of a new Office of Enforcement at the Bank Board with a staff separate from that of the Office of General Counsel.

The Bank Board at this point also had been working to impose controls over excessive deposit growth and risky operating practices at some institutions to which the Board attributed a large share of the blame for its increased problem institution caseload. Having tried unsuccessfully in 1984 to slow the growth of deposits at rapidly growing institutions by means of a regulation virtually banning the use of brokered insured deposits, the Bank Board turned to a more direct linkage between growth and capital.

In January 1985, the Board issued regulations tightening capital requirements, and hence limiting growth unless accompanied by sufficient capital. Even more pointedly, it required institutions that intended to grow at an annual rate in excess of 25 percent to first obtain approval from the supervisory authorities. The Board also asserted a federal oversight role with respect to the approval of direct investments by state-chartered institutions in real estate, equity securities and service corporations, to the extent that an institution intended to hold such investments which, in the aggregate, would amount to more than 10 percent of assets or twice net worth.

These regulations typify a broad and impressive move by the Bank Board in this period to limit the drain on the FSLIC fund by preventive measures. A later example of such rules was the new minimum net worth requirements in August, 1986, which mandate an eventual net worth level of at least 6 percent of assets for all institutions.

The effect of the rules was to impose a new, tighter discipline on all operators with the hope that those endangering their institutions and the FSLIC would be reined in. It should be noted that the U.S. League of Savings Institutions, while reserving the right to comment on specific aspects of various proposals, vigorously endorsed the policy of imposing more discipline on high-flying institutions. Indeed, the League took the initiative of a leadership role in calling for such discipline.

But all along, as the FSLIC's problem caseload continued to mount, the Bank Board made it clear that it still viewed recapitalization as an essential ingredient for a healthy FSLIC.

In November, 1985, U.S. League Chairman Gerald Levy appointed a task force to craft solutions to the funding problems of the FSLIC. The task force developed, and the U.S. League Board of Directors approved, a comprehensive set of recommendations. These included a recapitalization program which envisioned meeting the FSLIC funding shortage by agreeing, on a schedule phased down over time, to the continuation of the special insurance assessment on the business first imposed at the beginning of 1985 and by transferring to the FSLIC part of the Federal Home Loan Banks' capital surplus and future earnings. Together with other sources of FSLIC funds -- regular premiums and investment income -- this plan was projected to provide the FSLIC with total resources of $27 billion over the next 10 years.

In addition, the task force recommended 23 other remedial steps to be taken by the Federal Home Loan Bank Board, the FSLIC, Congress and the savings institutions business. Among them were techniques to give regulators early warning of impending trouble at institutions so they could stop behavior which led to failures or take control of failing institutions before they built up large losses. In general, the recommendations called for supervisors to get tough with the few managers who were operating imprudently and posed the greatest risks to the insurance fund and ultimately to the entire savings institution system.

While the U.S. League plan was being formulated, the U.S. Treasury and the Federal Home Loan Bank Board were also working on a plan to recapitalize the FSLIC. On the day the League's plan was to be publicly announced in Washington, the Treasury/Bank Board plan was outlined in press accounts.

As it happened, each proposal envisioned accumulating almost exactly the same total sum, although over slightly different periods. The fundamental difference between the two plans was that the one developed by the administration authorities called for borrowing most of the money to be used in case resolution from the capital markets, while the League's plan provided for the funds to be obtained as needed from internal resources of the savings institution business including the Federal Home Loan Bank System which is owned by savings institutions. Because it provided funds on an as-needed basis without borrowing, the League's proposal became known as the "Pay-as-You-Go" plan.

The borrowing in the administration plan would be undertaken through a specially created financing entity issuing bonds in the capital markets to raise between $10 billion and $15 billion. A $3 billion transfer from the Federal Home Loan Banks' reserves would be invested in zero coupon Treasury securities which in turn would be eventually used to repay the principal of these bonds. Interest on the bonds would become an ongoing obligation of savings institutions through their deposit insurance premiums and assessments. Over time, this debt service would amount to between $16 billion and $24 billion on the assumption that the bonds would have a maturity of 20 years.

The Administration submitted legislation to Congress to autherize this bonding approach to FSLIC recapitalization. The House and Senate Banking Committees adopted the plan and sent it to the full House and Senate. However, support for the bonding program with its enormous debt service burden was understandably shallow in the savings institution business. Moreover, related issues such as the proliferation of non-bank banks were linked to recapitalization by various members of Congress. To further complicate the plan's prospects, the Congressional Budget Office raised a serious question as to whether the proceeds raised by the bonds could be given the needed scoring as a government receipt for budget purposes. The latter question was subsequently resolved, but only after weeks of delay.

Thus, the plan stalled until the final weeks of the 99th Congress when the Senate Banking Committee Democratic spokesman, Senator Proxmire, proposed a compromise. The bonding plan would be limited to one year at the outset and a ceiling of $3 billion in bonding authority would be imposed. Subject to Congressional approval, the bonding authority could be renewed for subsequent years, if needed.

The Administration at first rejected the one-year compromise but in the closing hours of the session agreed to it. By then it was too late for action to be completed.

The U.S. League in November reconstituted its FSLIC Task Force with an added mandate to examine the regional economic problems affecting many of the nation's financial institutions and -- following the innovative example of the commercial bank regulators' forbearance guidelines issued in 1986 -- to develop recommendations for handling those institutions' problems without resorting to wholesale closings.

The program developed by the Task Force is described in the main body of this report.

APPENDIX D: IS THERE A COST TO THE FSLIC IN DELAYING ACTION IN THE FINAL RESOLUTION OF PROBLEM CASES?

One of the major criticisms of the U.S. League's pay-as-you-go plan is that it did not provide enough resources immediately to the FSLIC to allow it to solve its most pressing problems quickly. Implicit, and indeed sometimes explicit, in this criticism was the assertion that by not taking final action swiftly in dealing with problem institutions, the ultimete cost to the FSLIC would be greatly increased since the size and severity of the problems at such institutions would continue to grow.

This contention can be questioned on many grounds:

1. It is reasonable to assert that if problem institutions are left untended, the exposure of and eventual cost to the FSLIC will likely be increased. However, bringing such institutions under control is not necessarily synonymous with crafting a final resolution. The Bank Board has many ways of ensuring that institutions do not continue to increase the risks to the FSLIC. These include replacing management and boards of directors or formally taking the institution over and putting it in the Management Consignment Program. Indeed, responsible savings institutions, burdened with billions of dollars in special insurance assessments, affirmatively demand that the Bank Board ensure that such institutions are not allowed to continue to act in a manner likely to cost the industry even more money in the future.

   Assets taken over by the FSLIC can be conserved from further deterioration by active management through the auspices of the Federal Asset Disposition Association, through management by responsible institutions recruited through the Management Consignment Program or through other means.

   Once deterioration is halted, an informed decision can be made as to whether the best course is to dispose of such assets, bring them to completion if they are in the development stage or manage them on an income-producing basis. If immediate disposition is to the FSLIC's, the business' and, where appropriate, the community's advantage then that option is open. Providing further options that could increase the return to the FSLIC can only bo to the fund's advantage.

2. Adopting a rapid approach to the disposition of problem assets can actually be expensive for the FSLIC. As pointed out elsewhere in this report, the problem assets the FSLIC has taken over are concentrated in a few states, most notably states that are mired in economic difficulties. If the FSLIC were to dispose of those assets immediately, it would likely be doing so at fire-sale prices.

   In addition, these disposition efforts could further erode real estate values in those areas. This would lessen the return to the FSLIC itself, cause increased difficulties to other operating financial institutions and, generally, serve to deepen the depression in the affected areas.

3. An analogy to this situation was the plight of savings institutions in the unfavorable interest rate environment in 1981-82. As pointed out in Appendix A, by taking an essentially wait-and-see attitude at that time, the FSLIC saved itself $4.7 billion according to calculations by the GAO.

On the other hand, the GAO has been widely quoted as saying the FSLIC would suffer losses if it continued to "warehouse" insolvent thrifts until the end of 1987. For instance, in a transmittal letter to Rep. Doug Barnard, the Chairman of the House Subcommittee on Commerce, Consumer and Monetary Affairs, the GAO stated:

> "Our simulations predict that the FSLIC may lose over $1.4 billion from warehousing 367 thrifts from December 1985 to December 1987 if interest ratas do not change in this period. Moreover, even modest increases in interest rates result in substantially higher costs to FSLIC. Only if interest rates fall de our simulations predict that there will be a continued pattern of apparent savings to FSLIC." ["Cost of Delaying Action on Insolvent Savings Institutions", GAO, September 1986, pg. 4]

There are many problems with the methodology in the GAO study but its conclusion thet there is a significant cost to FSLIC in delaying action has been widely accorded the infallible status commonly granted to government statistics.

<u>However, if the GAO study is given credibility it shows, in fact, that the FSLIC will save somewhere approaching $4.5 billion by warehousing the 367 so-called insolvent thrifts from December 1985 to December 1987.</u> (This is in addition to the $4.6 billion the GAO computed as being saved by warehousing 107 insolvent thrifts from December 1982 to December 1985).

The GAO is explicit in this. For the level of interest rates over the 1985-87 period, it uses a mortgage rate of 11 percent. The study states:

> "...about $4.5 billion could be saved if interest rates fall by 2 percentage points" [op.cit. pg. 20]

This is basically what has happened since mortgage rates are approaching the 9 percent level in many parts of the country.

With its methodological problems, the cost-savings referred to by the GAO study may not actually be forthcoming. However, neither is it possible from the GAO's numbers to prove that there is a cost to the FSLIC in delaying final resolution on problem cases.

APPENDIX B: LEVERAGING 20 PERCENT OF THE FEDERAL HOME LOAN BANK SYSTEM'S NET INCOME

Under current rules, the Federal Home Loan Banks are required to place 20 percent of their income each year in what is called the legal reserve. Thus, this portion of their income is not available for use as dividend payments to their owners, the member savings institutions.

The U.S. League's funding plan for the FSLIC calls for dedicating this part of the Bank System's income stream to servicing possible borrowings by the FSLIC of up to $5 billion.

Specifically, if needed, a funding corporation would be established to issue long-term zero-coupon bonds. This corporation would then set up a sinking fund to retire the principal and interest on these bonds at the end of 20 years.

The Bank System would annually contribute to the funding corporation the greater of $275 million -- 20 percent of its estimated 1986 net income -- or 20 percent of its prior year net income. To ensure that the burden of contributing to the funding corporation did not fall unevenly on the individual banks or to obviate the possibility of a particular bank shirking its responsibility through minimizing its earnings, the net income for the system as a whole would be used as the calculation base. Twenty percent of this combined net income figure would be calculated. The resulting contribution would be levied on each bank by using the ratio of total assets of FSLIC-insured institutions in its district to the total assets of all FSLIC-insured institutions nationwide.

Exhibit 8 shows that if the Bank System's income grows at 9.53 percent per year, dedicating 20 percent of that income would be sufficient to pay off, in the year 2007, the total principal and interest on $2.5 billion of zero-coupon bonds sold in 1987 and another $2.5 billion issued in 1988 (with a combined face value of $22.4 billion in 2007). This assumes that the bonds can be sold with an interest rate of 8 percent. It also assumes that funds paid into the sinking fund would earn at an annual rate of 5 percent, a conservative assumption. Because they would be earmarked to retire long-term debt, there is no reason why such funds could not be placed in longer-term investments higher on the yield curve.

Of course, there is no guarantee that the Bank System's earnings would grow enough each year to provide sufficient contributions to the funding corporation, although the System's earnings have grown at an average annual rate of 14.7 percent since 1978. However, the Bank System is forecasting that its earnings in 1987 will grew very little and might even shrink. There are two main reasons for this pessimistic forecast:

1. A sizable portion of the System's earnings for the last year or more was made up of income from penalties on the early prepayment of advances by borrowing institutions. This is essentially a non-recurring source of income; and

2. The Federal Home Loan Banks derive the bulk of thair net income from earnings on their capital base. On other operations, they run at an essentially breakeven level. With the decline in interest rates, the earnings on their capital base have also declined.

If the System's earnings do not grow at the 9.53 percent necessary to pay off the borrowings, there would be a shortfall in contributions to the sinking fund. In that case, it is contemplated that the business would make up the difference.

However, it is also possible that the retained earnings of the Bank System could also be used as a reserve to help pay off the bonds if, after a period of, say, five years, it was determined that the resources already committed to solve the FSLIC's problems were sufficient and, therefore, it would no longer be necessary for them keeping the retained earnings in the background as a potential backing for future borrowings.

If the worst case scenario is assumed and Bank System earnings do not grow at all over the next 20 years (or if they decline), the Bank System would contribute the minimum $275 million each year. This would be sufficient to pay off the principal and interest on $2.1 billion of borrowings, leaving the business to pay off the principal and interest on the other $2.9 billion -- if a total of $5 billion is borrowed.

This represents the downside for the industry. To assume that the Bank System's earnings would be no higher 20 years from now than they are today is very pessimistic and, probably, totally unrealistic. If, for instance, the earnings of the Bank System grew at 5 percent per year, then the Bank System would be liable for the payment of interest and principal on $3.3 billion of the possible $5 billion in debt with the business being responsible for the other $1.7 billion.

The industry exposure under the U.S. League plan for various growth assumptions in Bank System earnings is compared in Exhibit 9 with the full special assessment which many feel would be the business' permanent inheritance under the Treasury/Bank Board plan.

/ EXHIBITS

EXHIBIT 1: SOURCES OF FSLIC EXTERNAL CASH FLOW UNDER ALTERNATIVE PROPOSAL

	U.S. League Pay-As-You-Go Plan	U.S. League Savings Insts. Self-Help Plan	Treasury/Bank Board Plan $10 B.	Treasury/Bank Board Plan $15 B.
TWO-YEAR CASH FLOW:				
Regular Premiums	$1.6 B.	$1.6 B.	$1.6 B.	$1.6 B.
Special Assessments	$2.2 B	$2.2 B.	$2.2 B.	$2.2 B.
Bank System Contribution	$2.1 B.	$0.0 B.*	$0.0 B.*	$0.0 B.*
Borrowings	$0.0 B.	$5.0 B.	$5.0 B.	$6.0 B.
Subtotal	$5.9 B.	$8.9 B.	$8.9 B.	$9.9 B.
less				
Interest on Debt	$0.0 B.	$0.0 B.	$0.2 B.**	$0.2 B.*
TOTAL	$5.9 B.	$8.9 B.	$8.7 B.	$9.6 B.
FIVE-YEAR CASH FLOW:				
Regular Premiums	$4.5 B.	$4.5 B.	$4.5 B.	$4.5 B.
Special Assessments	$4.3 B	$4.3 B.	$4.3 B.	$4.3 B.
Bank System Contribution	$4.0 B.	$0.0 B.*	$0.0 B.*	$0.0 B.*
Borrowings	$0.0 B.	$5.0 B.	$10.0 B.	$15.0 B.
Subtotal	$12.8 B.	$13.8 B.	$18.8 B.	$23.8 B.
less				
Interest on Debt	$0.0 B.	$0.0 B.	$2.0 B.**	$2.4 B.*
TOTAL	$12.8 B.	$13.8 B.	$16.8 B.	$21.4 B.
TEN-YEAR CASH FLOW:				
Regular Premiums	$10.4 B.	$10.4 B.	$10.4 B.	$10.4 B.
Special Assessments	$4.6 B	$4.6 B.	$4.6 B.	$4.6 B.
Bank System Contribution	$6.9 B.	$0.0 B.*	$0.0 B.*	$0.0 B.*
Borrowings	$0.0 B.	$5.0 B.	$10.0 B.	$15.0 B.
Subtotal	$21.9 B.	$20.0 B.	$25.0 B.	$30.0 B.
less				
Interest on Debt	$0.0 B.	$0.0 B.	$2.0 B.**	$8.4 B.
TOTAL	$21.9 B.	$20.0 B.	$19.0 B.	$21.6 B.
TWENTY-YEAR CASH FLOW:				
Regular Premiums	$29.1 B.	$29.1 B.	$29.1 B.	$29.1 B.
Special Assessments	$4.6 B	$4.6 B.	$4.6 B.	$4.6 B.
Bank System Contribution	$6.9 B.	$0.0 B.*	$0.0 B.*	$0.0 B.*
Borrowings	$0.0 B.	$5.0 B.	$10.0 B.	$15.0 B.
Subtotal	$40.5 B.	$38.7 B.	$43.7 B.	$48.7 B.
less				
Interest on Debt	$0.0 B.	$0.0 B.	$14.0 B.**	$20.4 B.
TOTAL	$40.5 B.	$38.7 B.	$29.7 B.	$28.3 B.

* Bank System Contributions do not go directly to the FSLIC. They are reflected instead as backing for the borrowings.

** Under the final version of the Treasury/Bank Board plan, the FSLIC does not actually pay the interest on the borrowings. Instead, the interest on the borrowings represent a first call on the premiums and/or assessments from the business. However, the interest payments are broken out as a separate obligation of the FSLIC in this table for the sake of clarity -- the net effect is the same. Under the League's self-help plan the Bank System (and perhaps the business) pays the interest.

Note: Detail may not add to total due to rounding.

EXHIBIT 2: THE EIGHTEEN STATES WITH THE MOST SEVERE ECONOMIC PROBLEMS AS MEASURED BY UNEMPLOYMENT, PERSONAL INCOME AND HOUSING STARTS

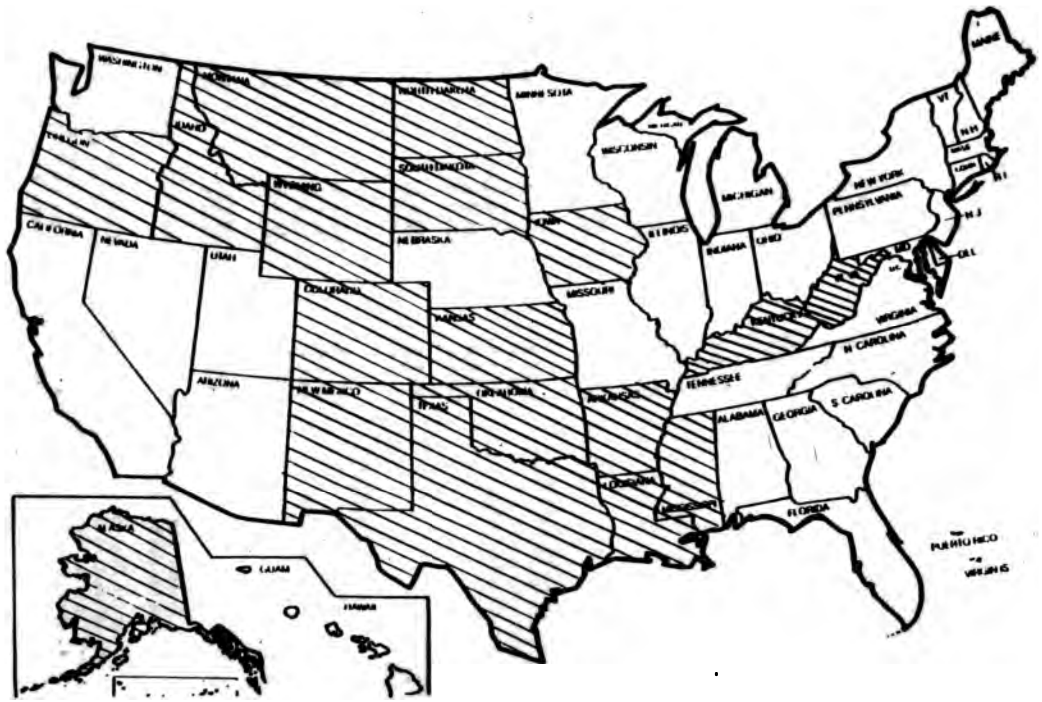

EXHIBIT 3: BANKS CLOSED BY FDIC -- 1982-86

(States are Included Only if they had Bank Closings)

	1986	1985	1984	1983	1982
Alabama	1	2	1	1	1
Alaska	1	0	0	0	0
Arkansas	0	1	2	1	3
California	8	7	6	5	2
Colorado	7	6	2	1	0
Florida	3	2	2	0	1
Idaho	1	0	0	0	0
Illinois	1	2	5	6	5
Indiana	1	1	2	0	0
Iowa	10	11	3	0	2
Kansas	14	13	7	1	0
Kentucky	2	0	1	1	0
Louisiana	8	0	1	0	0
Massachusetts	0	0	0	0	1
Michigan	0	0	1	0	1
Minnesota	5	6	4	1	1
Mississippi	0	0	1	0	0
Missouri	9	9	2	1	2
Montana	1	0	0	1	0
Nebraska	6	13	5	1	0
Nevada	0	0	0	1	0
New Jersey	0	0	1	1	1
New Mexico	2	3	0	0	0
New York	0	4	0	2	4
Oklahoma	16	13	5	1	3
Oregon	1	3	5	5	0
Pennsylvania	0	0	0	0	1
Puerto Rico	1	0	1	1	1
South Dakota	1	0	1	1	0
Tennessee	2	5	11	12	3
Texas	26	12	6	3	7
Utah	3	1	1	0	0
Virginia	0	0	0	0	1
Washington	0	0	0	0	1
West Virginia	0	0	1	0	1
Wisconsin	1	1	0	0	0
Wyoming	7	5	2	1	0
Total	138	120	79	48	42

Sources: FDIC, American Banker, Wall Street Journal

EXHIBIT 4: THE TWELVE STATES WITH THE MOST COMMERCIAL BANK FAILURES IN 1985 AND 1986

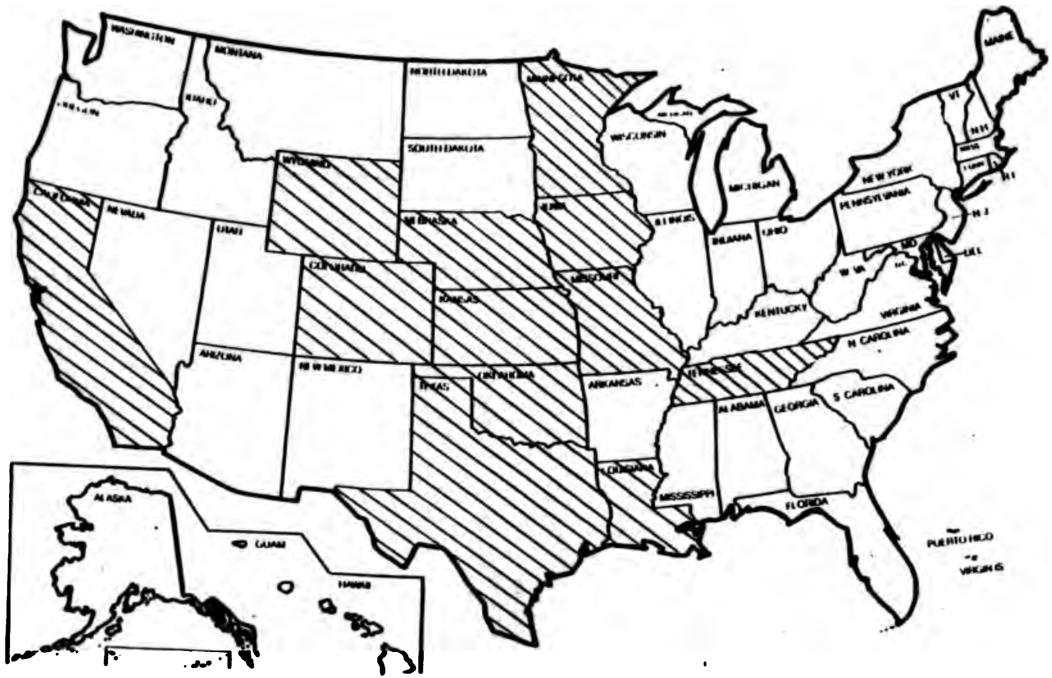

EXHIBIT 5: THE FOURTEEN STATES WHERE SAVINGS INSTITUTIONS LOST MONEY, ON THE AVERAGE, IN THE FIRST HALF OF 1986

EXHIBIT 6: FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

BALANCE SHEET -- SEPTEMBER 30, 1985 & 1986

ASSETS:	9/30/86	9/30/85	CHANGE
CASH & INVESTMENTS	$4,635,207	$5,761,337	($1,126,130)
SUBROGATED ACCOUNTS DUE FROM RECEIVERS	$6,115,864	$1,960,714	$4,155,150
ALLOWANCE FOR LOSS	($3,748,240)	($717,817)	($3,030,423)
COLLATERALIZED ADVANCES DUE FROM RECEIVERS	$663,257	$639,974	$23,283
LOANS TO RECEIVERS	$111,297	$0	$111,297
COLLATERALIZED LOANS TO INSURED INSTITUTIONS	$900,000	$900,000	$0
OTHER LOANS TO INSURED INSTITUTIONS	$120,141	$139,983	($19,842)
REAL ESTATE & MORTGAGES IN PROCESS OF LIQUIDATION	$402,714	$235,490	$167,224
INCOME CAPITAL CERTIFICATES	$2,270,642	$1,431,861	$838,781
ALLOWANCE FOR LOSS	($680,058)	($169,957)	($510,101)
NET WORTH CERTIFICATES	$288,500	$224,650	$63,850
OTHER ASSETS	($9,145)	$258,971	($268,116)
TOTAL ASSETS	$11,070,179	$10,665,206	$404,973

LIABILITIES:			
NOTES PAYABLE TO INSURED INSTITUTIONS	$3,692,541	$1,337,053	$2,355,488
NOTES PAYABLE TO FEDERAL HOME LOAN BANKS	$900,000	$900,000	$0
LOSS ALLOWANCE UNDER EXISTING ASSISTANCE AGREEMENTS	$686,687	$856,782	($170,095)
ESTIMATED CONTINGENT LIABILITY	$1,556,000	$0	$1,556,000
OTHER LIABILITIES	$597,811	$74,682	$523,129
TOTAL LIABILITIES	$7,433,039	$3,168,517	$4,264,522

INSURANCE FUND RESERVES:			
PRIMARY RESERVE	$2,824,956	$6,732,203	($3,907,247)
SECONDARY RESERVE	$812,184	$764,486	$47,698
TOTAL INSURANCE FUND RESERVES	$3,637,140	$7,496,689	($3,859,549)
TOTAL LIABILITIES AND RESERVES	$11,070,179	$10,665,206	$404,973

EXHIBIT 6 (Contd.): FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

INCOME STATEMENT FOR FISCAL YEARS 1985 & 1986

	FISCAL YEAR ENDED		
INCOME:	9/30/86	9/30/85	CHANGE
INSURANCE PREMIUMS	$724,284	$661,748	$62,536
SPECIAL ASSESSMENT	$1,063,159	$750,989	$312,170
INTEREST ON INVESTMENTS	$413,039	$539,610	($126,571)
PREMIUM ON TRANSFER OF ACCOUNTS	$118,607	$0	$118,607
OTHER INCOME	$68,490	$158,227	($89,737)
TOTAL INCOME	$2,387,579	$2,110,574	$277,005
EXPENSES:			
INTEREST ON NOTES PAYABLE TO INSURED INSTITUTIONS	$185,061	$92,441	$92,620
PROVISION FOR POSSIBLE FUTURE LOSSES ON:			
SUBROGATED ACCOUNTS DUE FROM RECEIVERS	$3,047,472	$591,968	$2,455,504
INCOME CAPITAL CERTIFICATES	$651,102	$77,207	$573,895
ASSISTANCE AGREEMENTS	$622,097	$571,560	$50,537
ESTIMATED CONTINGENCY	$1,556,000	$0	$1,556,000
OTHER	$60,109	$104,052	($43,943)
OTHER EXPENSE	$172,985	$179,418	($6,433)
TOTAL EXPENSES	$6,294,826	$1,616,646	$4,678,180
NET INCOME (LOSS) FROM OPERATIONS	($3,907,247)	$493,928	($4,401,175)
MEMO: TOTAL LOSS PROVISIONS	$5,936,780	$1,344,787	$4,591,993

SOURCE: FEDERAL HOME LOAN BANK BOARD

EXHIBIT 7: SAVINGS INSTITUTIONS'

SELF-HELP PROGRAM FOR FUNDING THE FSLIC

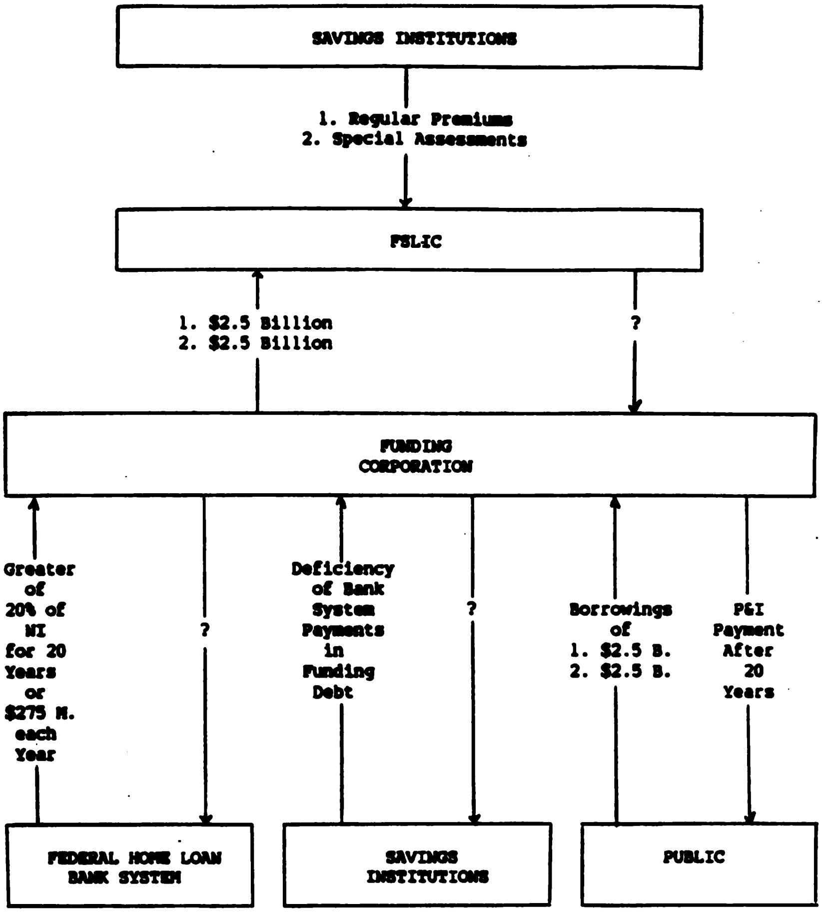

EXHIBIT 8: BORROWING CAPABILITY USING 20% OF BANK SYSTEM NET INCOME

ASSUMPTIONS:

TOTAL BORROWINGS	$5.00 BILL.
NEEDED FUNDS IN TWENTY YEARS	$22.44 BILL.
NEEDED GROWTH RATE OF SYSTEM EARNINGS	9.53%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.00%

YEAR	NET INCOME	BANK SYSTEM CONTRIB-UTION	AMOUNT IN SINKING FUND	BORROWINGS OUTSTANDING PRINCIPAL & INTEREST
1986	$1,375			
1987	$1,506	$275	$275	$2,500
1988	$1,649	$301	$590	$5,200
1989	$1,807	$330	$949	$5,616
1990	$1,979	$361	$1,358	$6,065
1991	$2,167	$396	$1,822	$6,551
1992	$2,374	$433	$2,346	$7,075
1993	$2,600	$475	$2,938	$7,641
1994	$2,847	$520	$3,605	$8,252
1995	$3,119	$569	$4,355	$8,912
1996	$3,416	$624	$5,196	$9,625
1997	$3,741	$683	$6,139	$10,395
1998	$4,097	$748	$7,195	$11,226
1999	$4,488	$819	$8,374	$12,125
2000	$4,915	$898	$9,690	$13,094
2001	$5,384	$983	$11,158	$14,142
2002	$5,896	$1,077	$12,792	$15,273
2003	$6,458	$1,179	$14,611	$16,495
2004	$7,073	$1,292	$16,633	$17,815
2005	$7,747	$1,415	$18,880	$19,240
2006	$8,485	$1,549	$21,373	$20,779
2007			$22,442	$22,442
TOTAL	$81,749	$14,928		
PRESENT VALUE OF CONTRIBUTIONS		$5,838		

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EXHIBIT 8 (Contd.): SHORTFALL IF BANK SYSTEM EARNINGS DO NOT GROW

ASSUMPTIONS:	
TOTAL BORROWINGS	$5.00 BILL.
NEEDED FUNDS IN TWENTY YEARS	$22.44 BILL.
GROWTH RATE OF SYSTEM EARNINGS	0.00%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.00%

YEAR	NET INCOME	MINIMUM BANK SYSTEM CONTRIB.	SHORTFALL MADE UP BY THE BUSINESS	AMOUNT IN SINKING FUND
1986	$1,375			
1987	$1,375	$275	$0	$275
1988	$1,375	$275	$26	$590
1989	$1,375	$275	$55	$949
1990	$1,375	$275	$86	$1,358
1991	$1,375	$275	$121	$1,822
1992	$1,375	$275	$158	$2,346
1993	$1,375	$275	$200	$2,938
1994	$1,375	$275	$245	$3,605
1995	$1,375	$275	$294	$4,355
1996	$1,375	$275	$349	$5,196
1997	$1,375	$275	$408	$6,139
1998	$1,375	$275	$473	$7,195
1999	$1,375	$275	$544	$8,374
2000	$1,375	$275	$623	$9,690
2001	$1,375	$275	$708	$11,158
2002	$1,375	$275	$802	$12,792
2003	$1,375	$275	$904	$14,611
2004	$1,375	$275	$1,017	$16,633
2005	$1,375	$275	$1,140	$18,880
2006	$1,375	$275	$1,274	$21,373
2007				$22,442
TOTAL	$27,500	$5,500	$9,428	
AMOUNT OF DEBT COVERED		$2,127	$2,873	
PRESENT VALUE OF CONTRIBUTIONS		$2,700	$3,138	

EXHIBIT 8 (Contd.): SHORTFALL IF BANK SYSTEM EARNINGS GROW AT 5% P.A.

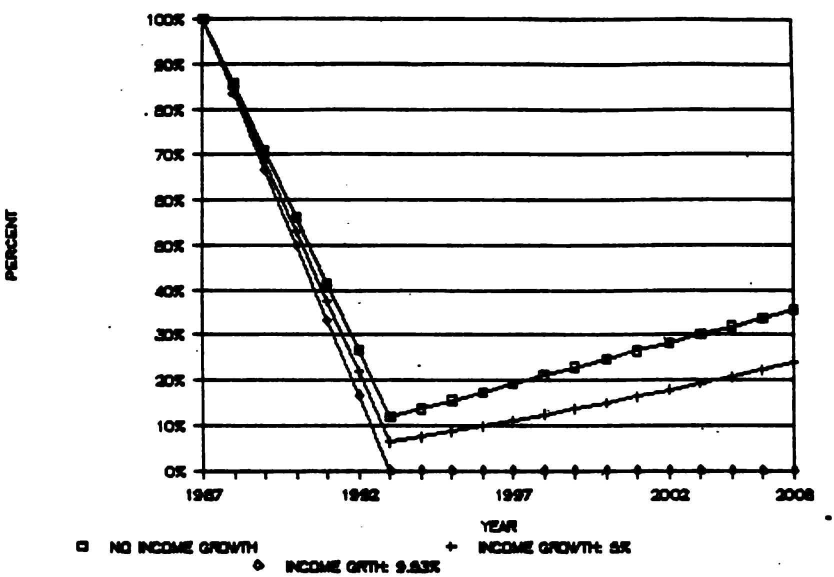
ASSUMPTIONS:

TOTAL BORROWINGS	$5.00 BILL.
NEEDED FUNDS IN TWENTY YEARS	$22.44 BILL.
GROWTH RATE OF SYSTEM EARNINGS	5.00%
EARNING RATE OF MONIES IN SINKING FUND	5.00%
LONG-TERM BORROWING RATE	8.00%

YEAR	NET INCOME	BANK SYSTEM CONTRIB.	SHORTFALL MADE UP BY THE BUSINESS	AMOUNT IN SINKING FUND
1986	$1,375			
1987	$1,444	$275	$0	$275
1988	$1,516	$289	$12	$590
1989	$1,592	$303	$27	$949
1990	$1,671	$318	$43	$1,358
1991	$1,755	$334	$61	$1,822
1992	$1,843	$351	$82	$2,346
1993	$1,935	$369	$106	$2,938
1994	$2,032	$387	$133	$3,605
1995	$2,133	$406	$163	$4,355
1996	$2,240	$427	$197	$5,196
1997	$2,352	$448	$235	$6,139
1998	$2,469	$470	$278	$7,195
1999	$2,593	$494	$326	$8,374
2000	$2,722	$519	$379	$9,690
2001	$2,859	$544	$439	$11,158
2002	$3,001	$572	$505	$12,792
2003	$3,152	$600	$579	$14,611
2004	$3,309	$630	$661	$16,633
2005	$3,475	$662	$753	$18,880
2006	$3,648	$695	$855	$21,373
2007				$22,442
TOTAL	$47,739	$9,093	$5,835	
AMOUNT OF DEBT COVERED		$3,251	$1,749	
PRESENT VALUE OF CONTRIBUTIONS		$3,948	$1,889	

EXHIBIT 9: MAXIMUM BUSINESS CONTRIBUTION IN LEAGUE PLAN

AS A PERCENT OF FULL SPECIAL ASSESSMENT



ASSOCIATION OF THRIFT HOLDING COMPANIES

900 17th Street, N.W., Suite 500
Washington, D.C. 20006
(202) 223-6575

BY MESSENGER

January 30, 1987

The Honorable Carroll Hubbard, Jr.
Chairman
Subcommittee on General Oversight
and Renegotiation
Committee on Banking, Finance, and
Urban Affairs
United States House of Représentatives
B304 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed, please find the documents you requested of us in the hearing of the House Committee on Banking, Finance, and Urban Affairs on January 21, 1987. Included are, to my knowledge, all of the comments filed with the Federal Home Loan Bank Board in response to the Board's proposal to extand the direct investment rule to January 1, 1989. In addition, I have provided a representative sampling of those comments, as requested. That sampling has included all comments that were drafted specifically for the proposed extension of the rule and omits only attachments and addenda to those comments.

If we can assist the Committee in any other way, please notify us.

Very truly yours,

Patrick A. Forte
President

PAF:my
Enclosures

USL
UNITED STATES LEAGUE of SAVINGS INSTITUTIONS 111 EAST WACKER DR./CHICAGO, ILLINOIS 60601 / TEL. (312) 644-31C

WILLIAM B. O'CONNELL
President

October 17, 1986

Director
Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

RE: Resolution No. 86-962

Dear Sir:

The U.S. League of Savings Institutions* would like to take this opportunity to comment on the Bank Board's September 17, 1986 proposal to revise its direct investment regulations, which, as currently cast, basically require institutions to obtain Bank Board permission before investing an aggregate of more than 10% of their assets in service corporations, equity securities and equity interests in real estate. Those regulations at present are scheduled to expire January 1, 1987,

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*The U. S. League of Savings Institutions serves the more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: Gerald J. Levy, Chairman, Milwaukee, Wisconsin; Joe C. Morris, Vice Chairman, Emporia, Kansas; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations: and Rita I. Fair, Senior Vice President, Regulatory Operations. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

and the Bank Board has sought public comment on whether that sunset date should be extended to January 1, 1989. The Bank Board also has asked interested parties to address the question of the continued need for the regulations in their present form in light of the agency's recent adoption of higher regulatory capital requirements for FSLIC-insured institutions. Finally, the agency has invited comment upon the administrative flexibility of the direct investment rule.

The U.S. League has recognized the potential threat to the FSLIC insurance fund posed by the excessive and unskillful making of direct investments, and supported the imposition by the Bank Board of the present structure of regulatory preapproval thresholds governing such investments. It is our strong impression that this structure has been effective in curbing the worst abuses in this area without depriving well-managed institutions of a reasonable opportunity to take advantage of the legitimate profit-making possibilities that direct investments offer.

Concerning the appropriateness of modifying the direct investment limits in view of the strengthened system of capital requirements recently imposed on FSLIC-insured institutions, including increased reserves required against direct investments, we believe that the possibility of a trade-off is quite promising, but are cognizant of the need to proceed

cautiously in this area. In light of the elimination for most institutions of the 10% safe harbor for direct investment reserves, the U.S. League would support as an immediate step a modest raising of the 10% direct investment threshold to 15% for organizations in compliance with their minimum capital benchmarks, but would regard any more ambitious lifting of constraints as deferrable until we have had actual experience with the workings of the restructured net worth requirements.

If this experience indeed reveals that the new net worth regulations are accomplishing substantially the same objectives as the direct investment limitations, then we certainly would favor extensive liberalization of those limitations. But, given the weakness of the FSLIC fund, we believe precipitate action to dismantle significantly the direct investment regulations would not be in the best interests of our industry or those it serves. We note, too, that delay would allow us to factor into the policy equation the impact of FSLIC recapitalization legislation, should it be enacted. Accordingly, the U.S. League suggests that the Bank Board refrain from making other than the modest adjustments noted above in the direct investment threshold figures at this time, and extend the regulations' expiration date to January 1, 1988, with the understanding that more comprehensive revision of the direct investment limits would be considered promptly at that time in light of experience gained with the new net worth regime.

With respect to the administrative flexibility of the direct investment rule, our impression is that initial fears of inflexible negativism have proven to be unfounded. On the other hand, we still hear complaints of excessive delays forestalling transactions. While recognizing the tremendous supervisory burdens being shouldered by the Bank Board staff at present, particularly in those FHLBank districts suffering widespread economic difficulty, we nevertheless would hope that steps could be taken to assure the minimization, if not elimination, of such complaints. Rapid processing of applications is absolutely central to the equitable functioning of the regulatory framework the Bank Board has erected in this area.

A final concern in the flexibility area has to do with the grandfathering of projects with definitive plans. Our understanding when the regulations were issued was that "definitive" by no means implied that grandfathering only extended to projects or segments thereof where the precise shape of the end-product was known in advance, but only that the institution was proceeding in a definite direction with a clear plan of operation. Real estate development projects frequently are evolutionary in nature, requiring the ability to react flexibly to opportunities as they occur. We hope the Bank Board will take advantage of the current rulemaking proceeding to clarify this point.

The U.S. League appreciates having had this opportunity to express its views on the proposal in question. If you have any questions regarding our positions, please do not hesitate to contact us.

Sincerely,

William B. O'Connell

William B. O'Connell
President

KAYE, SCHOLER, FIERMAN, HAYS & HANDLER
425 PARK AVENUE
NEW YORK, N.Y. 10022
212 407-8000

[illegible]

October 17, 1986

(212) 407-8355

BY HAND

Director
Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G. Street, N.W.
Washington, D.C. 20552

Re: Comments in Opposition to Proposed Rule to [illegible] for the Expiration of the Regulation Governing Direct Investments by Insured Institutions (51 Fed. Reg. 32925 (September 17, 1986))

Members of the Federal Home Loan Bank Board:

We represent Lincoln Savings and Loan Association ("Lincoln"), a California-chartered savings and loan association insured by the Federal Savings and Loan Insurance Corporation. Lincoln opposes the Federal Home Loan Bank Board's ("Board") proposed rule to defer the expiration of the regulation governing direct investments by insured institutions published at 51 Fed. Reg. 32925 (September 17, 1986). The proposed revision is both substantively and procedurally invalid because the Board lacks authority to promulgate it and because the Board has failed to provide an adequate comment period.

For the reasons set forth in the memorandum, dated July 10, 1984, which we previously submitted on behalf of Lincoln in opposition to the original Direct Investment Re-

> this approach has been effective in controlling risk and whether further regulatory action is required. For this reason, the Board has adopted the January 1, 1987, expiration date. 50 Fed. Reg. 6927 (February 19, 1985) (emphasis added).

Accord 49 Fed. Reg. 48756 (December 14, 1984) (Summary by the Board; Second Proposal). Accordingly, the Board intended that all of the issues raised in the initial rulemaking process would be re-examined thoroughly before the Regulation could be extended.

In fact, Congress itself, during the same year that the rule became effective, emphasized that based on the Board's evidence, the direct investment rule was designed only to be a temporary measure and that the evidence "was not sufficient to support a conclusion that such a rule would be needed over the long run." Federal Regulation of Direct Investments By Savings and Loan Associations, H.R. Rep. No. 358, 99th Cong., 1st Sess. 14 (Nov. 5, 1985). The House Report explained that:

> The long-term desirability of encouraging prudent risk taking suggests a presumption against a system of prior Federal restraints. . . .Specific new evidence will be needed if this presumption is to be overridden in the future. . . .Before engaging in rulemak ng to extend the direct investment rule, the Bank Board should conduct new and comprehensive empirical studies of thrifts' operating experience with direct investments in the period following implementation of the net worth and ADC loan accounting rules. Id. at 16-17.

In its Notice Of Proposed Rulemaking to extend the Direct Investment Regulation, the Board has ignored its own mandate; it has not attempted to evaluate the underlying basis for the regulation. Rather, it has directly circumvented its mandate by seeking only comments on the flexibility of the regulation and the continued need for it in light of its adoption of other regulations. Moreover, the recent empirical study cited by the Notice which purports to analyze the impact of direct investments held by failed thrifts on the FSLIC fund falls far short of the requisite full and thorough examination

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of the need for, and propriety of, regulating direct investments today. The Board states that this study demonstrates that, of those institutions that have failed, their direct investments were "positively related to the FSLIC's costs." 51 Fed. Reg. at 32926. These results simply do not address the issue of whether direct investments, by themselves, increase the risk of failure or increase FSLIC's costs. Moreover, even if the study (conducted by Board employees) is a complete analysis of the issues -- and it clearly is not -- the Board has not requested the public's comments on, and analyses of, these issues.

Accordingly, the Board is conducting its rulemaking in a manner directly inconsistent with its own and Congress' mandate. The current notice contravenes the type of review contemplated under the Direct Investment Regulation and, for this reason alone, it is invalid.

Very truly yours,

Peter M. Fishbein (ar)

Peter M. Fishbein

PMF:ph
Enc.

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M E M O R A N D U M

To: Lincoln American Savings and Loan Association

Date: July 10, 1984

From: Peter Fishbein, Esq.

Re: Proposed Rule of the Federal Home Loan Bank Board Limiting Direct Investments by Insured Institutions

This memorandum explains our conclusions that the Federal Home Loan Bank Board ("Board") does not have authority to promulgate the proposed rule published at 49 Fed. Reg. 20719 (May 16, 1984).

The Board states it is authorized to promulgate the proposed rule limiting direct investments under its statutory authority to supervise "unsafe and unsound" practices. While we express no opinion regarding the Board's authority to promulgate such regulations for federally-chartered insured institutions, the promulgation of such regulations for state-chartered insured institutions is beyond the Board's authority. The Board's proposed rule completely ignores Congress'

expressed intent that the integrity of the dual financial system, allowing federal and state chartering and control of such institutions, be maintained.

The reasons why the Board lacks such authority, discussed in detail below, are as follows:

1) The Board's statutory authority to supervise "unsafe or unsound practices" does not grant the Board rule-making authority to determine per se unsafe or unsound practices by state-chartered institutions;

2) The proposed rule impermissibly usurps the authority of the sovereign states explicitly preserved by Congress through the dual financial system and is therefore beyond the Board's authority; and

3) Promulgation of the proposed rule by the Board without additional time for comment and a full evidentiary hearing would be arbitrary, capricious and an abuse of its discretion because there is insufficient factual evidence before the Board that the direct investments which are the subject of the proposed rule are inherently unsafe or unsound.

1. The Board Lacks Statutory Authority To Determine By Rulemaking That Such Direct Investments By State-Chartered Institutions Are Per Se Unsafe Or Unsound.

The Board's statutory authority to institute cease-and-desist proceedings for "unsafe or unsound" practices re-

quires careful, case-by-case analysis by the Board of the specific facts regarding a particular insured institution. The legislative history of the Board's "unsafe or unsound" practices authority makes clear that such an individualized analysis must be done by the Board. By determining per se that certain direct investment practices by state-chartered insured institutions, allowed under state law, are unsafe or unsound, the Board has exceeded its statutory authority.

In considering whether to extend to the Board cease-and-desist authority for unsafe or unsound practices, Congress was particularly concerned with the definition of such practices. Board Chairman Horne submitted to Congress a memorandum in which he explained that "the term 'unsafe or unsound practices' has a central meaning which can and must be applied to constantly changing factual circumstances." 112 Cong. Rec. 26,474 (Oct. 13, 1966). His memorandum concludes by stating:

> It should be understood that in cease-and-desist proceedings based on . . . grounds [of unsafe or unsound practices], there would have to be a factual showing on the record which succeeds in convincing the hearing examiner or the Board, . . ., that the particular practice in the particular case should be characterized as "unsafe or unsound," and a cease-and-desist order issued.

Id. (emphasis added). Chairman Horne provided an attachment to his memorandum which contains categories of unsafe or unsound practices and four examples which are quite fact specif-

ic. Id. at 26,474-75. A full reading of Chairman Horne's memorandum and attachment makes clear that such findings by the Board were and would continue to be made on a case-by-case consideration of the specific facts and circumstances surrounding the allegedly unsafe or unsound practices. None of the practices discussed by Chairman Horne are allowed under state law. Congress therefore had absolutely no reason to believe it was granting the Board authority to determine that activities of state-chartered institutions allowed under state law would be ruled per se unsafe or unsound practices by the Board. Promulgation of the proposed rule therefore exceeds the Board's statutory authority.

The preamble to the proposed rule asserts that "Section 407 of the [National Housing Act] (12 U.S.C. 1730) authorizes the [FSLIC] to make rules and regulations defining practices it deems unsafe and unsound." In fact, 12 U.S.C. § 1730 does not authorize the Board to make rules prohibiting investments expressly authorized by state law. It merely authorizes the Board to make rules pertaining to adjudicative proceedings under 12 U.S.C. § 1730. 12 U.S.C. § 1730(m)(3).

The Board relies on Independent Bankers Association of America v. Heimann, 613 F.2d 1164 (D.C. Cir. 1979), cert. denied, 449 U.S. 823 (1980), for its authority to define by regulation practices of state-chartered institutions it deems

unsafe or unsound. Heimann considered the authority of the Comptroller of the Currency to issue regulations preventing insiders of nationally-chartered banks from engaging in certain practices which he considered "unsafe and unsound." In upholding the Comptroller's authority to issue such regulations, the court relied on Congress' intent that nationally-chartered banks be "meticulously regulated," which requires "the closest monitoring and continuous supervision of these institutions" by the Comptroller. 613 F.2d at 1168.

Because Heimann only raised the question of the Comptroller's authority to regulate national banks, and did not consider statutory requirements for notice and deference to state supervisory authorities regarding intended cease-and-desist proceedings against state-chartered institutions for unsafe or unsound practices, the Board's reliance on Heimann for its authority in the present case is totally misplaced. In Heimann, the court relied heavily on the Comptroller's authority, provided by Congress, to completely regulate national banks. The Board has no such authority over state-chartered institutions. See 12 U.S.C. § 1730(b) and (o). Congress has repeatedly stated its intent that each state retain control and supervision over the activities of institutions it charters.

A recent court ruling reiterates this point. The authority of the Federal Deposit Insurance Corporation (FDIC) and the Board to promulgate regulations affecting the insurance coverage of brokered deposits was struck down in FAIC Securities, Inc. v. United States of America, Civ. Action Nos. 84-0959 and 84-1136, slip op. (D.D.C. June 20, 1984). The court held that the "unsafe and unsound practices" provisions in 12 U.S.C. §§ 1730 and 1818

> relate to specific enforcement actions brought against individual banks, and the power to prescribe regulations which "effectuate the purposes" of those provisions clearly does not contemplate across-the-board regulations of the type at issue here.

Id., slip op. at 10 n.7 (emphasis added). The court reasoned that "if Congress has determined an issue, the agency is not free to change it." Id. It struck down the regulations as "inconsistent with the statute and therefore not lawful," and noted that courts must avoid the "temptation to approve good-faith agency efforts despite the agency's apparent lack of statutory authority." Id., slip op. at 12. Because the Board lacks statutory authority to completely regulate the activities of state-chartered insured institutions, and its proposed rule would prohibit investments allowable under certain state laws which Congress did not intend to be preempted by the Board, the proposed rule is beyond the Board's authority.

It is important to note that Judge Gesell wrote the opinions in both Heimann and FAIC Securities. The latter opinion, which obviously limits a broad extension of the Board's authority under Heimann, was not issued when the Board published its proposed rule. The Board might well have reconsidered its assertion of statutory authority to promulgate the proposed regulations limiting direct investment if it had the benefit of Judge Gesell's decision in FAIC Securities.

Similarly, reliance on the Board's promulgation of regulations concerning de novo institutions is misplaced. The Board's authority to set requirements for approving insurance applications of de novo, newly chartered institutions is far broader than its authority to control by regulation activities of state-chartered institutions which are explicitly allowed under state law. In fact, the Board's de novo authority is based on a different statute. See 12 U.S.C. § 1726.

The Board's only other citation of statutory authority is the memorandum by Chairman Horne which was submitted to Congress in 1966 and discusses the definition of an "unsafe or unsound practice." As noted above, Chairman Horne's memorandum makes clear that such findings by the Board were and would continue to be based on individualized consideration of the specific facts and circumstances surrounding the allegedly unsafe or unsound practice. All of the examples contained in

the memorandum involve practices that would be considered reckless in any business, *e.g.*, self-dealing, misleading accounting methods, inadequate investigations of loans, overappraisals of security property, and dividend rates that cannot be supported by income. None of these practices are specifically allowed by state law.

By determining *per se* that certain legal investment practices of state-chartered institutions are "unsafe and unsound," the proposed rule is totally contrary to Congress' understanding of the substance and procedure of such findings by the Board, as explained in Chairman Horne's memorandum. Furthermore, the case cited by the Board as quoting Chairman Horne's memorandum, *Gulf Federal Savings and Loan Association of Jefferson Parish v. Federal Home Loan Bank Board*, 651 F.2d 259 (5th Cir. 1981), *cert. denied*, 102 S. Ct. 3509 (1982), held that the Board did *not* have authority to determine that certain practices by a federally-chartered savings and loan association were unsafe or unsound.

The Board simply does not have the authority to state by regulation that certain direct investment practices by state-chartered institutions, allowed under state law, are *per se* unsafe or unsound.

2. Congress Did Not Intend That The Board Usurp, Across-The-Board, The Ability Of State-Chartered Institutions To Engage In Practices Allowed Under State Law Or The Authority Of The States To Supervise And Regulate Such Institutions.

Congress gave the Board carefully limited authority to find activities of state-chartered institutions to be unsafe or unsound. The Board was authorized to terminate the insured status of an institution for having "continued unsafe or unsound practices" in conducting its business under the Housing Act of 1954, Pub. L. No. 83-560, § 501(3), 68 Stat. 590. However, for such terminations of state-chartered institutions, the Board was required to "first give to the authority having supervision of the institution" a statement explaining the "practices or violations for the purpose of securing the correction thereof. . . ." The Conference Report makes clear that Congress intended the Board to respect and initially defer to the states and their supervisory authorities:

> The conference substitute adopted the Senate amendment with changes designed to assure that the amendment would not impair the supervisory authority of State and local bodies over insured institutions other than Federal savings and loan associations. The local supervisory authority would be given an opportunity to attempt to secure a correction of the unsafe or unsound practice before further action is taken by the Home Loan Bank Board to terminate the insured status of the institution.

H.R. Rep. No. 2271, 83d Cong., 2d Sess. 84 (1954) (emphasis added).

In 1966, Congress authorized the Board to terminate the insurance of an institution which is engaging or has engaged in an unsafe or unsound practice, or is in an unsafe or unsound condition, explicitly requiring notice to the "appropriate state supervisory authority" for the purpose of securing corrections. Financial Institutions Supervisory Act of 1966, Pub. L. No. 89-695, § 102(a), 80 Stat. 1036. Additionally, the Board was given authority to institute cease-and-desist proceedings if an insured institution "is engaging or has engaged, or [FSLIC] has reasonable cause to believe that the institution is about to engage, in an unsafe or unsound practice" in conducting its business.

The Board's authority to institute cease-and-desist proceedings for unsafe or unsound practices resulted from a compromise which explicitly recognized the dual financial system and the importance of maintaining state control and supervision of state-chartered institutions. Both the House and Senate Reports discuss the substance of this provision and explain that the Board is required to permit the state supervisory authority an opportunity to "take satisfactory corrective action" prior to the Board's commencing its own proceedings. H.R. Rep. No. 2077, 89th Cong., 2d Sess. 7 (1966); S. Rep. No.

1482, 89th Cong., 2d Sess. (1966), reprinted in [1966] U.S. Code Cong. and Ad. News 3532, 3534. The Senate Report is crystal clear on its intent to preserve the dual savings and loan system. It states:

> The committee was concerned with the effect of this bill upon the dual banking system and the dual savings and loan system, ... The committee did not wish to take any action which would do violence to the balance between State and Federal functions and responsibilities which underlies the dual banking system and the dual savings and loan system. On the contrary, the committee was in full agreement with the statement made by the [committee] chairman in his remarks before the National Association of Supervisors of State Banks at Williamsburg, Va., quoted in the hearings: "The duties and powers of the Federal Reserve Board and the FDIC are broad and sweeping. They must be in order to carry out their functions. But neither they nor the State member and insured banks nor the State bank supervisors should ever forget for one moment that the State banks are chartered by the States, and are operated under State laws, and are responsible first and foremost to the officials of the States which created them."

S. Rep. No. 1482, supra, at 3538 (emphasis added). The Committee therefore required that in cases involving a state savings and loan association, "the appropriate State supervisory authority must be notified and must be given an opportunity, during a reasonable time under the circumstances, to take effective corrective action -- or to convince the Federal agency it is mistaken if the State supervisory authority thinks this

is the case." Id. Finally, the Senate Report states that "the committee considers that the bill emphasizes the role of the State chartering and supervisory authorities, and in no way lessens the status of these State authorities." Id. at 3539 (emphasis added).

Both the hearings and the colloquies during the House and Senate floor debates make clear Congress' intent to maintain the integrity of the dual banking system and the authority of the states concerning activities of state-chartered institutions. Chairman Horne testified that:

> We have also been conscious, in drafting this bill, that under our dual system the primary responsibility for supervision of State-chartered financial institutions lies on the State authorities. We have no quarrel with that concept, ... Our objective is quite simply an effective backup capacity when needed, and hence we do not object to the amendments adopted by the Senate to assure State authorities of notice and opportunity for action or objection on their part before we commence a proceeding involving an insured State institution.

Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 Before the House Committee on Banking and Currency, 89th Cong., 2d Sess. 38 (1966) (emphasis added).

Chairman Horne made clear to Congress that the Board would proceed against unsafe or unsound practices engaged in by state-chartered institutions on a fact specific, case-by-

case basis which affords notice and deference to the state supervisory authorities. The proposed regulation, which disallows per se certain investments by state-chartered thrifts, which may be perfectly legal under the state laws which control those institutions, violates the Chairman's statements and Congress' insistence that state laws and the authority of state supervisory agencies not be undermined by the Board.

Discussions of the proposed legislation in the Senate contain expressions of concern by a number of Senators that the dual savings and loan system be protected. Senator Proxmire discussed the requirement that state supervisory authorities be given notice and an opportunity to take satisfactory corrective action regarding the practice alleged to be unsafe or unsound by the Board. He stated:

> This provision gives a very substantial measure of protection to the bank or savings and loan association involved. For all practical purposes it gives the state supervisor an opportunity to review the matter, to hear the institution's side of the story, and to bring the institution and the Federal agency together in a satisfactory solution of the problem. In my judgment, this is one of the most important and most significant features in the entire bill.

112 Cong. Rec. 20,081 (August 19, 1966) (emphasis added). An excerpt from the Committee Report was then printed in the Congressional Record, including the statement that:

> The committee concluded that the administration's request for additional flexible and effective supervisory power should be granted, within carefully guarded limits, in order to make sure that our banks and savings and loan associations would continue to serve the Nation effectively and well.

Id. at 20,083 (emphasis added).

The Senate bill providing cease-and-desist authority for unsafe or unsound practices was debated again on August 22, 1966, at which time Senator Morse of Oregon expressed concerns communicated to him by officers of Oregon State banks. Senator Morse stated that:

> The general tenor of these letters was a fear that enactment of the bill would mean the further deterioration and eventual destruction of the State banks, and of our dual banking system.
>
> I am advised by the counsel to the committee that the committee amended S. 3158 in certain ways that bear upon the objections presented to me.

112 Cong. Rec. 20,244 (August 22, 1966). Senator Morse explained one of the objections as follows:

> First. The bill gives discretionary authority to Federal agencies to institute cease-and-desist procedures against State-chartered banks. This would put the Federal authorities in a dominant role over State banks, whereas the Oregon banking division of the Oregon Department of Commerce already has such powers and is the agency which issues charters to State banks. The supervisory responsibility of the [Oregon] State Department of Commerce would be grossly undermined.

Id. (emphasis added). Senator Proxmire characterized these remarks as useful to "the legislative history on the bill." Id. He then explained that:

> This bill provides safeguards. We provide that, before the Federal regulatory agencies can act with regard to State banks, that notice shall be given to State banks and supervisors. After that notice is given, they have the opportunity to discuss the situation with the Federal authorities, and perhaps to dissuade the Federal authorities from action.

Id. (emphasis added).

When asked whether "the Federal authorities can act only if the State authorities fail and refuse to do so," Senator Proxmire responded that "this is true for State banks" with the exception of suspensions and removals of officials based on charges or convictions for a felony involving dishonesty or breach of trust. Id. at 20,245. Senator Cooper stated that he intended to vote for the bill and noted in particular that "the manager of the bill [Senator Proxmire] has stated that ... the Federal Home Loan Bank Board will follow these procedures" which allow the state supervisory authority to effectuate corrective action for each specific situation. Id. at 20,246.

The proposed legislation was again discussed in the Senate on October 13, 1966. The requirement that a state banking authority "will have the first opportunity to correct

any situation and to present findings to the appropriate Federal agency" was reiterated. 112 Cong. Rec. 26,476 (statement by Sen. Cooper). Additionally, Chairman Horne's memorandum discussing the term "unsafe or unsound practices" and the fact specific nature of such findings was reproduced. The Senate clearly considered deference to and recognition of the important role of states in supervising state-chartered institutions as critical in obtaining passage of the legislation. . .

The debate in the House also focused on the dual savings and loan system. See 112 Cong. Rec. 24,984 (Oct. 4, 1966) (statement by Rep. Patman). Both houses of Congress were extremely concerned with the possible effects of granting the Board authority to issue cease-and-desist orders against state-chartered institutions for allegedly unsafe or unsound practices as restricting the supervisory and regulatory authority of states and state agencies in controlling state-chartered institutions.

Congress understood that "unsafe or unsound practices" were to be determined by the Board through careful analysis of all facts regarding an insured institution's operations. It additionally recognized that state-chartered institutions were empowered under state law to engage in certain activities, and were extremely concerned that federal agencies not usurp the power to control and regulate the operation of

such institutions. The proposed regulation goes beyond the Board's authority and Congress' understanding of the Board's role and procedures in determining whether practices of state-chartered institutions are unsafe or unsound.

In _First National Bank of Bellaire v. Comptroller of the Currency_, 697 F.2d 674 (5th Cir. 1983), the court both affirmed and set aside orders by the Comptroller against a nationally-chartered bank to cease and desist certain activities considered unsafe or unsound. In discussing the Comptroller's authority to issue cease-and-desist orders and Congress' stated intent, the court noted that "[t]he Comptroller must not become so obsessed with protecting the integrity of the national banking system that individual banks are arbitrarily treated unfairly [footnote omitted]." 697 F.2d at 681. The court went on to state that "[i]t is important to remember that [cease-and-desist orders] are limited to practices with a reasonably direct effect on a bank's financial stability." _Id_. Stating by regulation that investments by state-chartered institutions which are allowed under state law are _per se_ unsafe or unsound, without considering all other facts relating to a particular institution's financial stability, is tantamount to treating state-chartered institutions arbitrarily and unfairly.

The statute and legislative history explicitly show Congress' intent to allow supervision and regulation of state-chartered institutions to remain with the states. Additionally, it evidences Congress' understanding that the Board's authority to control unsafe or unsound practices of state-chartered institutions would be exercised on a case-by-case basis, giving deference to the views of the state supervisory authorities and careful consideration to all facts regarding the financial integrity of each such institution. The proposed rule violates Congress' intent on both points. When a sovereign state's legislature empowers its chartered, insured institutions to make direct investments or engage in other activities, the Board is not authorized by Congress to prohibit or restrict such activities by blanket regulation.

Congress granted the Board authority to institute cease-and-desist proceedings for unsafe or unsound practices on the explicit condition that state supervisory authorities receive advance notice and a substantial opportunity to object or disagree with the Board's judgment. This delicate balance was intended to insure the continuation and vitality of our dual savings and loan system. If the Board did not promulgate the proposed rule, it would have to proceed on the basis of cease-and-desist proceedings in each factual circumstance regarding such direct investments which it believes result in

unsafe or unsound practices. If the proposed rule is codified, any insured institution which violates it will be in violation of the regulation and therefore may have its insurance terminated or be subject to a cease-and-desist proceeding simply on the basis of having violated the rule. Congress gave the Board no such authority regarding state-chartered institutions.

Courts have consistently recognized Congress' intent in preserving authority of states and state agencies over state-chartered institutions. In Otero Savings and Loan Association v. Federal Home Loan Bank Board, 665 F.2d 279 (10th Cir. 1981), the court affirmed FSLIC's cease-and-desist authority and denied the Board's authority to issue a remedial order for an insured state-chartered institution to cease offering certain services. The case involved a violation of a law, rule or regulation rather than an alleged unsafe or unsound practice. However, the court noted that "Otero, as a state-chartered institution, is not subject to the same all-encompassing regulation 'from its cradle to its corporate grave' as are federally chartered institutions. . . ." 665 F.2d at 285 (citation omitted). It goes on to state, "[o]bviously, the fact that a state chartered institution such as Otero is insured by the FSLIC does not divest the appropriate state agencies of jurisdiction over it." (emphasis

added). Id. In a footnote to this statement, the court noted that in "promulgating § 1730(e) as part of the Financial Institutions Supervisory Act of 1966, Congress explicitly recognized the dual nature of federal and state regulation of state savings and loan associations by enacting § 1730(o)" and quoted the entire section. 665 F.2d at 285 n.4. As noted in dictum:

> Congress's intent in creating cease-and-desist powers was to grant the Bank Board and other federal agencies supervising banks and savings and loan associations "additional flexible and effective supervisory powers . . . , within carefully guarded limits, in order to make sure that our banks and savings and loan associations would continue to serve the Nation effectively and well."

665 F.2d at 288 (quoting S. Rep. No. 1482, 89th Cong., 2d Sess., reprinted in [1966] U.S. Code Cong. and Ad. News at 3538) (Holloway, J.) (emphasis in original). Similarly in First State Bank of Hudson County v. United States, 471 F. Supp. 33 (D. N.J. 1978), aff'd, 599 F.2d 558 (3d Cir. 1979), the court held that the FDIC could not be held liable under the Federal Tort Claims Act for failing to report exceptions to proper banking practices to the bank's board of directors because the federal agency did not owe a duty to regulate and so inform the bank's board of directors. In support of this holding, the court stated: "First State is a state-chartered bank. It is not a member of the Federal Reserve System. The

primary function of regulation and supervision, therefore, is one to be carried out by the New Jersey Commissioner of Banking, not by the FDIC." 471 F. Supp. at 35 (emphasis added). The court's reasoning and holding were affirmed on appeal, relying on the obligations created under New Jersey law. 599 F.2d 558.

The language of the statute authorizing cease-and-desist proceedings by the Board, 12 U.S.C. § 1730(e), (f), and (o), Congress' intent as stated in committee reports and discussions on the floor of the House and Senate, and court interpretations of cease-and-desist authority over state-chartered institutions are clear. They vest primary regulation and supervision of insured state-chartered institutions with the states and state authorities. The Board's proposed rule usurps this authority by stating that certain direct investments are *per se* unsafe or unsound. The provision of the proposed rule providing a procedure for waiver of the direct investment limitations is extremely burdensome and does not give sufficient deference to the role or views of the states and their supervisory authorities. The proposed rule therefore exceeds the Board's authority.

3. Promulgation Of The Proposed Rule Without Additional Time For Comment And A Full Evidentary Hearing Would Be Arbitrary, Capricious And An Abuse Of Discretion Because There Is Insufficient Factual Evidence That Direct Investments By State-Chartered Institutions, Allowed Under State Law, Are Unsafe Or Unsound Practices.

As explained by Chairman Horne, determinations by the Board of unsafe or unsound practices are to be made on a case-by-case basis with careful consideration of all facts regarding the financial integrity of an insured institution. This procedure was formalized in Memorandum R4, "Unsafe or Unsound Practices," issued by the Board on August 9, 1967.

The only factual basis given by the Board in its notice of proposed rulemaking is the "losses associated with the development of the I-30 corridor in Dallas, Texas" 49 Fed. Reg. 20,720. Press reports suggest the I-30 losses resulted from fraud or gross incompetence in granting loans rather than from direct investment activities. Such anecdotal evidence is an insufficient basis for the Board to determine by regulation that all direct investments above the stated limit are unsafe or unsound. At a minimum, the institution's full investment portfolio, method of operation, and all aspects of its financial integrity must be considered. If the Board is relying on additional evidence that certain direct investments are unsafe or unsound, it should be made available so that the public may

comment on it. Without an opportunity to review such evidence, the public is deprived of a meaningful opportunity to comment on the proposed rule.

An agency's action may be found arbitrary and capricious if the agency "has relied on factors which Congress has not intended it to consider, [or] entirely failed to consider an important aspect of the problem. . . ." Motor Vehicle Manufacturers Association v. State Farm Mutual Insurance, 103 S. Ct. 2856, 2867 (1983). In this case, the Board has entirely failed to consider facts regarding the safety and soundness of direct investments, preservation of the dual financial system, and deference required by statute to be given to the views of the states and the state supervisory authorities.

As you know, studies suggest that the direct investments which would be limited by the proposed rule are in fact profitable and socially beneficial rather than risky, unsafe or unsound. Instead of proceeding based on anecdotal evidence, the Board should conduct a full hearing on the safety and soundness of such investments by state-chartered institutions before promulgating the proposed rule. In the absence of such a hearing, or clear evidence that in all cases investments over the stated limits are in fact unsafe or unsound, the Board will be acting in an arbitrary and capricious manner

and will be abusing its discretion. As Chairman Horne informed Congress:

> The concept of "unsafe or unsound practices" is one of general application which touches upon the entire field of the operations of a financial institution. For this reason, it would be virtually impossible to attempt to catalog within a single all-inclusive or rigid definition the broad spectrum of activities which are embraced by the term. . . . Contributing to the difficulty of framing a comprehensive definition is the fact that particular activity not necessarily unsafe or unsound in every instance may be so when considered in the light of all relevant facts.

Chairman's Memorandum, 112 Cong. Rec. at 26,474. Fact specific determinations of what are unsafe or unsound practices should be made before the Board prohibits by regulation certain investments allowed under state law by state-chartered institutions.

COMMENT ON PROPOSED
AMENDMENT TO FEDERAL HOME
LOAN BANK BOARD REGULATION
OF DIRECT INVESTMENT BY INSURED
INSTITUTIONS 12 CFR § 563.9-8(h)
EXTENDING THE RULE'S EFFECTIVENESS
UNTIL JANUARY 1, 1989.

SUBMITTED BY:

ASSOCIATION OF THRIFT HOLDING COMPANIES

October 17, 1986

INTRODUCTION

On September 17, 1986 the Federal Home Loan Bank Board ("Board") published a proposed rule that would, if adopted, amend the current rule on Regulation of Direct Investment by Insured Institutions ("direct investment rule"). The proposed amendment would extend the application of the current rule from January 1, 1987 to January 1, 1989. This amendment to the sunset provision of the direct investment rule would leave in place for an additional two years a regulation that has been the subject of great controversy, that is legally deficient, and that is not supported by empirical evidence.

The direct investment rule limits the aggregate holdings of institutions insured by the Federal Savings and Loan Insurance Corporation ("FSLIC") in real estate, service corporations, equity securities, and the like to a maximum of the greater of ten percent (10%) of the institution's total assets or twice the institution's net worth. That limitation may be waived by the Federal Home Loan Bank that acts as Principal Supervisory Agent ("PSA") for the institution upon application from the institution. The PSA must consult with the state agency that oversees the institution applying for a waiver, but need not accede to such agency's wishes in the matter of the waiver. The PSA may deny the application if it determines that one of the four broad, and somewhat vague,

findings can be made that suggest to the PSA that the direct investments would present a risk that the PSA did not care to accept.[1] If an institution's application for a waiver is denied by the PSA, it may appeal that decision to the FSLIC for redetermination.

The proposed extension of the direct investment rule by the Board in the present rulemaking is insupportable for the following reasons: (1) the Board's procedures in conducting this rulemaking are in violation of its rules of practice and its own regulations; (2) the Board lacks sufficient statutory authority to promulgate the direct investment

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1 Specifically, the findings are:

> "(A) The overall policies, condition, and operation of the applicant afford a basis for supervisory objection;
>
> (B) The proposed investment or level of investment is likely to increase either the applicant's risk of default or the financial exposure of the Corporation;
>
> (C) The direct investments of the applicant and its service corporations and operating subsidiaries in equity securities and real estate are not appropriately diversified. Direct investments shall be deemed to be "appropriately diversified" if the consolidated direct investments of the applicant and its service corporations and operating subsidiaries in equity securities and real estate, when deemed to be those of the applicant, meet the requirements of paragraph (e) of this section; or
>
> (D) The applicant's policies are inconsistent with economical home financing, as evidenced by its failure to comply with the definition of a "qualified institution" as set forth in §.584.2-2(b) of this chapter."

rule; (3) the Board has usurped the role of state regulators granted by Congress as part of the dual (Federal and State) banking system; and (4) the Board's proposed extension of the direct investment rule in the absence of empirical evidence supporting it is arbitrary, capricious and an abuse of discretion.

PROCEDURAL DEFICIENCIES

The procedures adopted by the Board in promulgating the rule in question are deficient and open to serious legal challenge. The deficiencies arise in the Board's imposition of a truncated public comment period for the proposed extension, and in the Board's failure to grant a requested public hearing.

First, the period for public comment on the proposed rule is legally insufficient for the following reasons: (1) the Board's restriction of the public comment period to 30 days is an unjustified contravention of its own Resolution on Rulemaking and Regulatory Simplification mandate that the public be given 60 days to comment on proposed rules; (2) the 30 day comment period cannot be justified on grounds that the direct investment rule has previously been the subject of public comment, because 30 days allows insufficient time for public consideration and comment upon the two years of experience that have transpired since the previous comment period; (3) the shortened comment period is inconsistent with the Board's past practice of citing the

need for prompt action in the public interest only where exigent circumstances required a change of Board policy or rule; (4) the comment period as proposed treats the extension of the direct investment rule as if it were a minor procedural matter rather than an important and controversial issue with significant consequences for the thrift industry; and (5) the proposed comment period is too brief for reasoned public comment upon the volume and scope of empirical studies that examine tha direct investment rule.

In 1980, the Board adopted Resolution 80-594 addressing its rulemaking practices, which mandates a 60-day comment period except when at least one of eight specifically listed circumstances obtained.[2] The Board, to maintain any reasonable degree of consistency in its practices, must limit its exceptions to this stated policy to only the most exigent of circumstances or to wholly unimportant and non-controversial rules. In this instance, two exceptions have been cited by the Board: (1) the rule has been previously published for public comment and (2) the public interest requires prompt action.[3]

As to the exception for revisions to previously published rules on which there has been comment, it is correct that the direct investment rule has been the subject of extensive public comment and debate. However, the direct

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2 Federal Home Loan Bank Board Resolution No. 80-594, 45 Fed. Reg. 63135.

3 Proposed Rule, 51 Fed. Reg. 32925.

investment rule contains a sunset provision precisely because it was intended to cover a specific temporary period, and during that period the specific experience under the rule could be drawn upon for consideration of modification, elimination or extension. Thus, there is a whole new universe of experience available for public comment that was not available when the rule was previously considered.

The Board's use of the exception for reduced public comment in the event that prompt action is <u>required</u> to protect the public interest is even less supportable. The specific examples of such exigent circumstances listed in the Board's governing Resolution include matters such as furthering Board housing goals, responding to adverse market conditions, and correcting errors.[4] Similarly, the Board's own use of this public interest exception over the last two years indicates that it has consistently been cited only where some <u>change</u> in the Board rules was necessary to effectuate a <u>change</u> in behavior or circumstances of the regulated industry. Simply put, the Board has utilized the public interest exception only where exigent circumstances required prompt action to effectuate a change. Previously, the Board has not used the public interest exception to attempt to justify a truncated comment period on a proposed continuation of a current and ongoing policy or rule.

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[4] Res. No. 80-584 at 3(b).

The direct investment rule is a substantive matter affecting hundreds of regulated institutions, and its extension for two additional years may not be treated as if it were a mere procedural issue. In January, 1985, members of the House of Representatives considered the rule so controversial and important that 226 Representatives joined in sponsoring H. Con. Res. 34 expressing the sense of Congress that the rule's effective date should be delayed while more Congressional investigation was completed. Additionally, the House Committee on Government Operations was quite explicit in its report on the direct investment rule that "[b]efore engaging in rulemaking to extend the direct investment rule, the Bank Board should conduct new and comprehensive empirical studies of thrift's operating experience with direct investments in the period following implementation of the net worth and ADC loan accounting rules" (Emphasis added).[5] In light of such previous expressions of concern with conducting exhaustive analysis of the basis for the direct investment rule, the Board's choice of an abbreviated comment period is unsupported by necessity, arbitrary, and an abuse of the Board's discretion.

Finally, the direct investment rule has been the subject of much debate and study both before and after the promulgation of the rule in March 1985. Indeed, the OPER

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5. Twenty-First Report by the Committee on Government Operations, November 5, 1985 at page 17.

study[6] cited by the Board in support of the proposed extension of the rule lists 57 studies that bear on the evaluation of even the limited matters that it addresses. Of these referenced studies, 20 have been completed since the last rulemaking in which the direct investment rule was considered. It is unreasonable and a further abuse of discretion for the Board to take the position that an issue as complex and controversial as the direct investment rule can be properly and adequately addressed, when parties have only 30 days in which to gather the applicable studies, examine their own relevant experience, evaluate the often conflicting findings of the studies and their experience, prepare their comments, and file such comments with the Board. Under such circumstances, a failure to allow at least 60 days for public comment suggests that the Board is not interested in receiving or considering meaningful comment on the proposed rule. Moreover, the failure to allow 60 days for public comment is an unjustified violation of the Board's own rules of practice.

Second, the Board may not proceed with the instant rulemaking without first holding public hearings, if such hearings are requested by more than 25 members of the Federal Home Loan Bank System in accordance with the provisions of 12 CFR § 507.10. That section, in relevant part, requires the

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6 Barth, Brumbaugh, and Sauerhaft, Failure Costs of Government-Regulated Financial Firms: The Case of Thrift Institutions, June 1986.

Board to set a time and place for the conduct of public hearings on the proposed regulation to which the requesting members object. Furthermore the regulation is quite clear that the proposed rule to which the hearing requestors object may not be made effective until after such hearings are conducted.

This regulatory provision and its precursers have stood unchallenged as a check upon unnecessary or unseemly haste by the Board in the adoption of regulatory provisions since the Board's very inception. Except for slight modifications, in each instance deemed by the Board to be procedural rather than substantive, essentially the same regulatory provision has existed as a part of the Board's regulations governing the Federal Home Loan Banks and the institutions which make up the Federal Home Loan Bank System since the Board initially published regulations in the Code of Federal Regulations in 1938. As part of a procedural reorganization of all of the Board's regulations in 1958, the Board combined the two previous provisions that granted the right to request a hearing on a proposed (or existing) regulation, respectively, to the Federal Home Loan Banks and the institutions that are members of the Federal Home Loan Bank System, and to the members of the system and the Federal Savings and Loan Advisory Committee. The combined provision

was moved to Subchapter A of the Board's regulations to take its place alongside other provisions of general applicability to the many roles played by the Board.

Lest it be argued that § 507.10 is not intended to apply to regulations, such as the instant extension of the direct investment rule, that govern activities of institutions as they relate to the Federal Savings and Loan Insurance Corporation; it must be noted that the Board has promulgated both § 507.10 and § 563.9-8 (the direct investment rule) under authority of § 17 of the Federal Home Loan Bank Act ("Bank Act").[7] Further, repeatedly, the Board has argued that the Bank Act and the National Housing Act, under which most FSLIC regulations are promulgated, must be read together as an integral whole operating to promote a system of economical home financing.[8]

In addition, the Board has cited § 507 as one of the procedural sections generally applicable to the question of whether or not a hearing is required in promulgating the direct investment rule.[9] While on those occasions hearings were denied, presumably that was because requests had not been made in the form and number required by § 507.10.

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7 See: 23 Fed. Reg. 9878, at 9880. 50 Red. Reg. 6912, at 6914.

8 50 Fed. Reg. 6912, at 6914.

9 _Id_. at 6914.

The proposed rule for the extension of the direct investment rule is certainly one that falls within § 507.10's ambit as "relating to the Federal Home Loan Banks." The Banks play an integral role in the direct investment rule's scheme for allowing waivers. Specifically, if an institution wishes to make direct investments in excess of the rule's threshold limit of ten percent (10%) of total assets or twice net worth, then it must apply to its regional Federal Home Loan Bank, acting in the role of Principal Supervisory Agent, for a waiver. The Banks in their roles as Principle Supervisory Agents are even more directly involved in the implementation of the direct investment rule than the Board itself.

If the Board promulgates a final rule without first extending the period for public comment or without first holding the public hearings required by § 507.10 of its own rules, it will do so in violation of its rules of practice and its regulations. These defects -- particularly the failure to conduct a hearing mandated by the regulations -- would be sufficient to invalidate the proposed rule.

INSUFFICIENT STATUTORY AUTHORITY

The Board has previously considered and dismissed arguments that it is without sufficient statutory authority to promulgate (or, by analogy, to extend) the direct invest-

ment rule. However, the Board's position on the question of statutory authority is seriously undercut by its own characterization of the facts.

In brief, the Board's assertion of statutory authority to promulgate or extend the direct investment rule rests on two principles arising out of the interplay between the National Housing Act ("NHA") and the Federal Home Loan Bank Act: (1) the development and maintenance of a system of sound and economical home financing; and, (2) the protection of the FSLIC fund from undue risk.

First, the Board had cited to § 402(a) of the NHA (12 U.S.C. 1725(a)) as empowering the Board to prescribe rules and regulations for carrying out the purposes of the NHA.[10] The Board then asserts that "[s]ince the direct investment regulation is designed to maintain safe, sound, and economical home financing as well as to protect the FSLIC fund from undue risk, the rule carries out the purposes of the NHA and so represents a permissible exercise of regulatory authority under section 402(a)."[11] The mere assertion; however, of the design or purpose of a regulation is not sufficient to support the argument presented. For the Board to be correct in its analysis of the scope of authority provided by the language of § 402(a) of the NHA, it must prove that the regulation in question, in fact, does carry

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10 50 Fed. Reg. 6912.

11 50 Fed. Reg. 6912.

out the asserted purposes of the act. Moreover, the Board is not free to issue broad ranging regulations, such as the direct investment rule, if such rules are inconsistent with the authorities granted to financial institutions by virtue of the provisions of the NHA and the Bank Act.

In an effort to bolster its assertion of statutory authority the Board has cited to its much more specific authorizations under §§ 407(b) and 407(m) of the NHA to terminate insurance coverage entirely and to initiate cease and desist proceedings to prevent "unsafe or unsound practices." The Board then implies that it is a "less drastic power"[12] to merely prevent unsafe or unsound practices by regulatory prohibitions such as the direct investment rule.[13] The Board is subtly and rather cavalierly ignoring the fact that its rule imposes a burden across the board on all FSLIC insured institutions without regard to whether their individual practices are unsafe or unsound. The Board implies that, because it could take drastic action under authority of the statute against one institution whose unsound practices could be proven, it may subject all institutions to such "less drastic" actions as it sees fit.

This was precisely the type of Board-instituted draconian measure that a district court overruled in FAIC Securities Inc. v. United States, No. 84-0959, slip op.

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12 50 Fed. Reg. 6912, at 6914.

13 Id., at 6914.

(D.D.C. June 20, 1984). There the district court held that the Board could not, by regulatory fiat, virtually eliminate FSLIC coverage for deposits placed through deposit brokers. The court indicated that the provisions of the NHA gave the Board the authority to regulate unsafe and unsound practices as they "related to specific enforcement actions" but "do not support" this regulation (id. at 9 n.7). Moreover, the court was not persuaded that the NHA provided for across-the-board regulations such as the one then in question and, by analogy, such as the direct investment rule.

The Board's assertion of statutory authority to issue the direct investment rule prohibitions based on the purpose of preventing unsafe or unsound practices is sharply undercut by the Board's repeated assertions that it makes no finding that direct investments are inherently unsafe or unsound. The most the Board seems willing to say is that some direct investments are unsafe or unsound, or that in some sets of circumstances they present too great a risk to the FSLIC. No one would seriously argue with those propositions. Moreover, it is just this case by case nature of determining what is unsafe or unsound that the stature intended as the Board's role in protecting the integrity of the FSLIC. Nothing in the Board's characterizations of direct investments leads to a conclusion that the broad-sweeping limitations currently imposed on an entire industry by the Board are supported by either logic or statute.

USURPATION OF STATES' ROLES

As with concerns about statutory authority, the Board has previously had occasion to consider and reject arguments that its system of regulating direct investments is in contravention of Congressional purpose in creating the dual (Federal and State) banking system. While the Board attempts to characterize its scheme for the regulation of direct investments as including a meaningful role for state regulators, it has reduced that role to that of an insignificant and powerless commentator. The states no longer have the practical ability to determine what kinds and amounts of investment are appropriate to the localized conditions of its state-chartered institutions. The Board's regulations usurp all of the ultimate power to determine investment guidelines.

The direct investment scheme created by the Board provides state regulators only a hollow, powerless opportunity to comment on the appropriateness of granting a waiver. It must be noted that the PSA need not accede to the preferences of the state regulator. Further, the entire waiver process is an imposition placed upon <u>state</u>-chartered institutions without regard for the state determination that must already have been made to allow the direct investment in question.

Congress has consistently sought to maintain the dual banking system, allowing there to co-exist both federal and state chartered institutions. One of the great benefits

of our federal system of government is that the various agencies of the states often take a quite different approach to the regulation of some segment of the economy than do their federal counterparts. This diversity has great value in allowing local differences to prevail, in providing many models from which to gain experience, and in maintaining closer connections between regulators and the regulated. With its direct investment rule the Board chooses to supplant all such benefits in the regulation of financial institutions with its own all encompassing fiat, based on the scarcest of empirical evidence. Within the dual system fostered by Congress, the Board simply does not have sufficient authority to usurp the role of state regulators.

As discussed supra, the Board does not have statutory authority to define an entire class of investment behavior as an "unsafe or unsound" practice. The statutory provisions to which the Board looks for support for its position do not grant such authority and certainly did not contemplate that the Board would impose such a broad judgment on practices which properly impowered state authorities had decided to permit for state chartered institutions.

The Board relies heavily on the cease and desist authority granted to it by Congress in 12 U.S.C. § 1730(b) for the purpose of curtailing "unsafe or unsound" practices. The legislative history indicates that neither the Congress nor the Board itself contemplated that such authority should

be used in anything other than a case by case approach. On behalf of the Board, then Chairman Horne provided Congress with a telling conclusion on the proper application of the "unsafe or unsound" practices determination:

> . . . there would have to be a factual showing on the record which succeeds in convincing the hearing examiner or the Board, . . ., that the particular practice in the case should be characterized as "unsafe or unsound," and a cease-and-desist order issued.[14]

Going further, Chairman Horne's submittal to Congress quite plainly envisioned that the unsafe or unsound practices determination would be made in an individual, case specific, recorded proceeding. The examples of unsafe or unsound practices suggested to Congress by Chairman Horne were equally fact specific. It is not credible to now assert that Congress intended to grant the Board the authority to ignore the express provisions of state law allowing certain kinds or amounts of investment and to determine such practices to be "unsafe or unsound."

The Board, perhaps recognizing the foregoing arguments has responded that it is not defining direct investment to be unsafe or unsound practices, but merely setting threshold limitations which, when exceeded, trigger requirements that an institution apply for a waiver. If, indeed, the Board does not rely upon the authority of 12 CFR § 1730 (b) to issue cease an desist orders, then it is left without any

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14 112 Cong. Rec. 26,474, October 13, 1966.

base for its imposition of the direct investment rule upon state chartered institutions. The Board must choose its statutory bases and stay with them. It cannot prohibit behavior on the basis of the authority to order an institution to cease and desist from unsafe or unsound practices, and at the very same time assert that it has made no determination that the prohibited behavior is unsafe or unsound.

The Board indicates reliance upon Independent Bankers Association of America v. Heimann, 613 F.2d 1164 (D.C. Cir. 1979), cert. denied, 449 U.S. 823 (1980) to establish its authority to define unsafe or unsound practices. The Heimann case resolved, in favor of the government, the question of whether the Comptroller of the Currency had sufficient authority to issue regulations prohibiting certain conduct by "insiders" of federally chartered banks on the ground that such conduct was "unsafe and unsound." The regulations were issued under a statute similar to 12 CFR § 1730 (b) upon which the Board relies.

The circumstances of the Heimann case were, however, quite different. The banks regulated were federally chartered, thus there had been no state law determination that the practices in question were expressly permissible. Moreover, the Comptroller of the Currency was not engaged in a shell game of implying that specific types of practice are unsafe or unsound for purposes of enlisting statutory authority and, at the same time, saying that he had not

deemed them unsafe or unsound for purposes of avoiding an apparent conflict with both empirical facts and contrary state determinations.

More to the point is the more recent decision in FAIC Securities, Inc. v. United States of America, Id., discussed supra. There the district court was dealing directly with the Board's statutory authority and held that the unsafe and unsound practices referred to in 12 U.S.C. 1730 relate to specific enforcement actions brought against individual banks, and the power to prescribe regulations which "effectuate the purposes" of those provisions clearly does not contemplate across-the-board regulations of the type at issue here.[15]

Congress has reserved a role in the dual system for state regulations of state chartered institutions and, absent specific instances of unsafe or unsound practice, has given the Board no authority to remake the determinations of the states. As the Court in FAIC noted we must guard against the "temptation to approve good-faith agency efforts despite the agency's apparent lack of statutory authority."[16] The Board's well meaning intentions aside, it simply has no authority to substitute its judgment for that of the states in their area of regulation.

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15 Id., slip op. at 10 n.7.

16 Id., slip op. at 12..

Even in those instances where the Board has been given authority to take action to terminate the insured status of a state chartered institution upon the specific determination of unsafe or unsound practices by that specific institution, the Board is required by statute to first give state regulators notice and the opportunity to attempt to correct the unsafe or unsound practice. This provision recognized the essential quality of the dual system to be that the states remain the primary regulators of the state chartered institutions. Indeed, in testimony supporting the provision, Board Chairman Horne stated;

> We have also been conscious, in drafting this bill, that under our dual system the primary responsibility for supervision of State-chartered financial institutions lies on the State authorities. We have no quarrel with that concept. . . . Our objective is quite simply an effective backup capacity when needed and hence we do not object to the amendments adopted by the Senate to assure State authorities of notice and opportunity for action or objection on their part before we commence a proceeding involving an insured State institution.[17]

In sum, the Board cannot assert authority over the direct investment activities of state chartered institutions without invoking what it refers to as the "less drastic powers" inherent in the authority to issue cease and desist orders or termination of insured status orders whenever an institution is engaged in "unsafe or unsound" practices.

[17] Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 Before the House Committee on Banking and Currency, 89th Cong., 2d Sess. 38 (1966).

However, because the states have already explicitly determined that direct investments in general are permissible and therefore not "unsafe or unsound," and because empirical evidence will not support a general finding that direct investments are unsafe or unsound *per se*; the Board is unable to make any such determination. The Board's prohibitions against direct investments are thus invalid, as they lack the necessary statutory authority when applied to state chartered institutions.

INSUFFICIENT EMPIRICAL EVIDENCE

The Board's proposed extension of the direct investment rule is not supported by empirical evidence of a relevant or convincing nature. Even if it were assumed that the Board took action to correct the procedural defects of this rulemaking, that the necessary statutory authority could be found to justify the rule, and that proper accommodations were made to allow the states to play their proper role; the proposed rule lacks sufficient grounding in fact to survive legal challenge.

The Board had stated originally that the direct investment rule was designed to prevent "unsafe and unsound practices that otherwise would expose the institutions and the Insurance Fund to an unacceptable level of risk."[18] Later, the Board cited the additional concern that institutions might exercise direct investment powers granted by the

states "in a manner inconsistent with their obligation to provide economical home financing."[19] When the final direct investment rule was adopted, the Board stated that it was "designed to allow institutions the flexibility to exercise their investment powers, as independently authorized by applicable law, in a manner that would not expose either the institutions themselves or the FSLIC insurance fund to an unacceptable level of risk, while at the same time ensuring that these institutions continue to fulfill their obligation to provide economical home financing."[20] Finally, in proposing the extension of the direct investment rule, the Board has repeated without alteration this last formulation of purpose.[21]

It is worth noting that the Board makes no attempt in the rule as adopted or in its various supporting statements to define what constitutes "an unacceptable level of risk" or what constitutes the extent of the institutions' "obligation to provide economical home financing." The Board appears to be perfectly willing to leave such terms vague and undefined, perhaps, precisely because there is no empirical basis for asserting that any particular objective level of risk is created by increasing levels of direct investment to institutions themselves, to the FSLIC fund, or to the home

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19 49 Fed. Reg. 48743, at 48744, December 14, 1984.

20 50 Fed. Reg. 6912, February 19, 1985.

21 59 Fed. Reg. 32925, at 32925 and 32926, September 17, 1986.

financing market. Indeed, there are many indications that suggest that increasing levels of direct investment by a relative few institutions in the system are wholly unrelated to the purported purposes of the rule.

The Board's use of certain empirical studies and supervisory experience to attempt to make a connection between direct investments and the stated purposes of the rule limiting them requires the closest scrutiny. The Board's arguments fall into three broad categories: (1) those that attempt to show a link between increasing direct investments and decreasing availability of home financing funds; (2) those that attempt to show a link between increasing direct investment and increasing risk of failure to the institution; and (3) those that attempt to show a link between increasing direct investments and increasing costs to the FSLIC fund in the event of institution failure. The first and second categories would relate, rationally, to the regulation of all institutions within the Federal Home Loan Bank System. If the concerns posited there were born out by empirical evidence and experience, the strictures necessary to alleviate the concerns might logically be applied to all institutions. On the other hand, if only the link between direct investments and increased cost to the FSLIC in the event of failure were established, then a rule which makes no attempt to differentiate between institu-

tions which present a likelihood or probability of failure and institutions which are financially healthy is both logically and legally overbroad in its scope.

Of particular interest in regard to the appropriate scope of the rule is the experience which the rule itself has provided. Commendably, the Board recognized the somewhat tenuous empirical underpinnings of the rule as issued in February of 1985 and provided a sunset provision that would allow it to "assess, after sufficient experience with the rule, whether the approach taken had been effective in controlling risk and whether further regulatory action was required."[22] Less commendably, the Board seems not to have taken the opportunity to seriously reflect on whether the rule has any relationship to the Board's original concerns and rationale.

In proposing that the rule be extended for an additional two years the Board has offered no evidence, whether empirical study or supervisory experience, to establish the supposed link between direct investment activity and a reduction in the availability of economical home financing. Indeed, the Board, except for repeating its concern about home financing fails to mention that category of concern at all. To find any support for the Board's concern one must search the statements of the Board made

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22 51 Fed. Reg. 32925, at 32926.

prior to the rule's adoption.[23] Even there the most the Board has been able to do is point to the relative higher percentage of direct investments in the portfolios of some institutions and (because such percentages by definition entail a zero-sum situation) the relative lower percentage of home mortgages in such portfolios. Several points must be noted: (1) the Board has not shown in the two years of the rule that those instances of increasing direct investment caused a diminution in the actual dollar value of outstanding home mortgages; (2) the Board has made no attempt to show that the overall home financing market has been reduced or even affected by direct investment; (3) the Board has ignored suggestions that the benefits of direct investments may actually make greater dollar values (through smaller percentages) available to home financing; and (4) the Board has ignored the degree to which the greater returns on direct investments may have increased the stability of some institutions thereby assuring that they will continue to exist in the long term and continue providing economical home financing. In sum, it must be said that there is neither empirical data nor supervisory experience to support the inclusion of concerns for continued home financing as a basic purpose for adopting or extending the direct investment rule.

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23 See generally, 50 Fed. Reg. 6912 at 6918.

Similarly, the Board's latest proposal for the extension of the direct investment rule contains no support for the Board's asserted concern that increased direct investments are linked with a greater probability that institutions will fail. In fact, as with the concern for home financing availability, the rationale supporting the proposed extension is silent on the subject of increased risk of institution failures save for reiterating the concern itself.

The question of whether or not increased levels of direct investment are linked to failures has been the subject of much comment, study, and analysis since the inception of Board proposals to limit direct investments.[24] One point stands out clearly in all of the debate over this issue -- not one study, of all those conducted, has found a correlation between direct investment levels and institution failures.

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[24] See generally:

Barth, James R.; Brumbaugh, R. Dan, Jr.; Sauerhaft, Daniel; and Wang, George H.K. "Thrift-Institution Failures: Causes and Policy Issues," Bank Structure and Competition, Federal Reserve Bank of Chicago, 1985, pp. 184-216.

Barth, James R.; Brumbaugh, R. Dan, Jr.; Sauerhaft, Daniel; and Wang, George H.K. "Insolvency and Risk-Taking in the Thrift Industry: Implications for the Future," Contemporary Policy Issues, Fall, 1985.

Benston, George J., and Kaufman, George G., "Risks and Failures in Banking: Overview, History, and Evaluation," mimeo, December 1985.

Benston, George J. An Analysis of the Causes of Savings and Loan Association Failures.

Absent any study to support its concern, the Board has chosen to offer a few, somewhat vague references to examples of supervisory experience in which it believes that direct investments played a role in causing institution failure.[25] As others have noted for the Board in the past, these individual examples are all associated with another, more powerful failure causing factor -- fraud and mismanagement. While the direct investment activities of such failing institutions may very well be a proper subject of concern for the Board, they do not represent the state of the industry as a whole.

The Board appears all too willing to combine these isolated instances of mismanagement caused failure with certain questionable data which suggests a link between direct investment levels and the cost to FSLIC of such failures. The result at which the Board arrives from this statistically insupportable combination is that direct investment levels must be related to the risk of institution failure. Not only does the Board fail to provide a single piece of empirical analysis which would support such a leap of regulatory faith, it also ignores the conclusions of studies which have examined that question and failed to find any such connection.[26] The Board has chosen to either

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[25] 49 Fed. Reg. 48744, at 48748-48749.

[26] See:

Barth, James R.; Brumbaugh, R. Dan, Jr.; Sauerhaft, Daniel;
(footnote continued)

quibble with the methodology of studies whose outcome it does not like,[27] or to adopt convenient and convoluted explanations for why the outcome of the analysis is not what the Board predicts.[28]

Because the Board has chosen in the rationale for the proposed extension to rely so heavily on the empirical study of Barth, Brumbaugh, and Sauerhaft of the Board's Office of Policy and Economic Research ("OPER") on the Failure Costs of Government-Regulated Financial Firms: The Case of Thrift Institutions (June 1986), it bears particular examination to determine what light it may shed on the question of a link between direct investments and the likelihood of institution failure. First, it must be understood that the OPER study took no consideration whatever of healthy or non-failed institutions. The only conclusions which may be reliably drawn from the study are conclusions which relate exclusively to institutions which have already failed -- a very small and unrepresentative subset of the thrift industry. The sample limitations make it absolutely clear that any attempt to use the study, as the Board does, to

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(footnote continued from previous page)
and Wang, George H.K. "Thrift-Institution Failures: Causes and Policy Issues," Bank Structure and Competition, Federal Reserve Bank of Chicago, 1985, pp. 184-216.

Benston, George J. An Analysis of the Causes of Savings and Loan Association Failures.

27 50 Fed. Reg. 6912, at 6915.

28 Barth, Brumbaugh, Sauerhaft, and Wang. Thrift Institution Failures: Causes and Policy Issues, at p.26.

imply that there is some link between direct investment and the likelihood of failure is a gross misuse of the study's findings.

Moreover, it is important to understand that the basic data upon which the OPER study is founded contains a strong possibility of bias. The "actual cost" to FSLIC of the failures studied is not in the ordinary sense of the word an "actual" figure at all. It is, rather, the FSLIC's estimate of costs based on its valuation of the assets and liabilities of the failed institutions.[29] There is the very real possibility that the OPER study really only has value in examining the estimation biases of the FSLIC. More directly, it may be that the statistically significant link that the OPER study found between direct investments and the cost to FSLIC of failure, is really only a quite predictable tautology. If the FSLIC estimators are predisposed to believe that direct investments are inherently risky and of relatively less value than other more traditional assets of thrifts and build that predisposition into their "actual costs" estimations, then any examination of such "actual costs" would have to identify direct investments as a significant contributor to cost of failure. Moreover, the existence of such a bias would explain the apparent anomaly in the failure of the previous work of the OPER study authors to find any link between direct investments and the occur-

[29] Barth, et al. 1986, footnote 25, at p. 32.

rence of failure itself. Since the question of whether or not there has been a failure does not hinge on FSLIC estimations, the possibility of bias cannot affect the outcome.

In sum, there is no evidence empirical or experiential to support the need to limit direct investments for two of the three fundamental purposes the Board set out for the direct investment rule. There is only a single empirical study of limited sample, with potentially biased data, to support the need for the limitations with regard to the third purpose set out by the Board. Nothing in the Board's proposal supports a link between direct investments and a reduction in economical home financing. Nothing in the Board's proposal supports a link between direct investment and the causes of institution failures. The only possible link is between direct investments and the cost to FSLIC of failures. In view of these conclusions the extension of the application of the direct investment rule to all institutions without regard to their financial stability is overbroad and an abuse of the Board's regulatory discretion.

SAVINGS
AND LOAN ASSOCIATION
Gerald H. McQuarrie
Chief Executive Officer

October 14, 1986

Chairman Edwin J. Gray
Federal Home Loan Bank Board
1776 "G" Street, N.W.
Washington, D. C. 20552

OCT 17 10 57 AM '86

RE: COMMENT ON REGULATION OF DIRECT INVESTMENTS (86-962)

Dear Chairman Gray:

After the experience of being in an MCP Program with Butterfield Savings for the past year, it is readily apparent that various controls must be maintained by regulatory authorities to curtail rapid growth. We are in complete agreement with the regulations on asset growth and the new requirements on maintenance of adequate net worth.

In analyzing the provisions of the new net worth requirement regulation, it is our belief that it adequately covers any potential problems of both growth and investment. We, therefore, urge you to not extend the direct investment regulation past Janaury 1, 1987.

Sincerely,

Gerald H. McQuarrie
Chief Executive Officer

GHM;pr

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Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

October 15, 1986

Gentlemen:

On September 11, 1986, the Federal Home Loan Bank Board notified system members of its intent to readopt its Regulation of Direct Investment by Insured Institutions. By this action, the Board would extend the Direct Investment Regulation expiration date to January 1, 1989, rather than January 1, 1987. Further, the Board requested comments from the industry on the Regulation, its administration and the continued need for the rule.

When the initial rule was published for comment, the Texas Savings and Loan League responded at length regarding its content and its thrust. The essence of the League's position was that direct investment, if indeed it posed serious risks for the FSLIC, should be tailored to the capitalization of our member institutions, not to the arbitrary limits which could only be exceeded by supervision making business decisions for member management.

Quite recently the FHLBB adopted a new rule governing member capitalization requirements much in line philosophically with the recommendation made by the League in 1984. The new rule adopts a set of extraordinarily stringent requirements governing not only direct investments, but also loans collateralized by the land and construction outlays of its improvement. Moreover, the rule incorporates a 6% capital factor on any liability growth above the level prevailing as of December 31, 1986.

It is the clear belief of the Texas Savings and Loan League that the provisions of the newly adopted capitalization requirements are <u>more</u> than stringent enough to accomplish the FHLBB's goal in <u>severely</u> restricting direct investments. As a consequence, the Texas Savings and Loan League believes that 12 CFR Part 563 is redundant and is no longer required to accomplish the FHLBB's objectives.

The League therefore strongly and unanimously urges the FHLBB to abandon its current regulation on direct investments. In view of the newly adopted regulations governing member capitalization, the present rule on direct investments serves no useful purpose.

Very truly yours

Tom S. King

Tom S. King,
Executive Vice President

TSK/lmm

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WESTERN SAVINGS

Gary H. Driggs
President

October 15, 1986

Director
Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, DC 20552

Gentlemen:

Re: Comment Reference the Proposed Extension of the
Direct Investment Regulation

The Federal Home Loan Bank Board is considering an extension for two years of the direct investment regulation. When the original regulation was proposed, Western Savings made numerous suggestions many of which were adopted in the final regulation. We have supported the direct investment regulation both in letters to the Federal Home Loan Bank Board and in testimony for congress. The regulation has served a very important purpose of focusing attention on the potential risk and in providing appropriate supervisory review on oversight of direct investments. However, the proposed extension perhaps should be evaluated in the light of the additional important regulations which have been subsequently adopted by Federal Home Loan Bank Board. These regulations include the recently adopted higher net worth requirements, the asset classification requirements, and the accounting definitions of loans versus direct investments. All of these regulations have focused on the appropriate concern of the bank board that association's be adequately capitalized, that sufficient capital be provided for investments that have potential great risk factors, and that losses be recognized in accordance with generally accepted accounting principles, and that Federal Home Loan Bank Board examiners focus on the quality of assets at savings institutions.

It is the view of Western Savings that the recently passed regulations substantially solve the concern that the bank board had with the exposure to the FSLIC of direct investments. The new net worth proposals provide for higher capital requirements as direct investment levels increase. These new capital requirements are very substantial. In addition, there are growth limitations on association's that do not have high capital requirements. In the past problems with associations have been very closely correlated with high growth institutions. The recently adopted regulations have addressed those primary concerns. The recently adopted net worth regulation recognized that land acquisition and development loans, construction loans, and direct investments all have similar characteristics. We therefore feel that the board has appropriately dealt with those broad areas of concern with limitations on growth and through higher net worth levels. We therefore believe that the direct investment regulation can be modified without increasing the exposure of the FSLIC.

zs/da

The following suggestions would seem to be an appropriate modification based on our experience:

1. The preapproval for direct investments would remain for all associations not meeting the new higher net worth benchmark standards.

2. The limitation for preapproval be increased to 20 percent for associations meeting the increased net worth requirements.

3. No limitations should be placed on associations with respect to direct investments where the net worth exceeds six percent.

The present regulation provides that associations may complete direct investments where the association had a definitive plan to complete a project as of the adoption of the existing direct investment regulation. This requirement places an undue burden on both association's and regulatory officials. There must be made by the supervisory agent a determination as to what was a definitive plan and association's must spend significant amounts of time and administrative effort in trying to document what was in the minds and plans of the association's as of December 10, 1984. Regulatory officials by their nature are not geared up for the rapid rate of decision making required by the completion of real estate developments. It is inappropriate to place the responsibility and burden on supervisory agents to get into the middle of real estate development activities and to place a burden of approval of the adequacy of plans. In the case of an association failing to meet its higher regulatory net worth it is entirely appropriate for regulatory officials to assert a higher level of control. Since the time of regulatory officials is necessarily limited their efforts should focus on those institutions who are failing to meet regulatory requirements and not be in a business planning or decision making mode for association's who are in compliance with the new higher net worth standards.

It would therefore seem appropriate for the direct investment regulation to be completely relaxed except for the additional net worth requirements for high net worth association's exceeding a 6% net worth level and for association's that are on schedule to meet the 6% level for there to be some relaxation in the completion of already grandfathered projects and that regulatory oversight be concentrated on those association's failing to meet the net worth standards. Direct investments have become a very emotional issue and in some cases the Federal Home Loan Bank Board has suggested that whenever a failure has occurred any loan that the association took back was in fact a direct investment disguised as a loan. In a sense this is true any loan that goes bad is by definition a direct investment. However, such a determination does not really mean that the association intended to make a direct investment at the time. Bad loan judgements and underwriting, as well as, changes in economic

zs/da

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circumstances such as those experienced by the energy and agricultural sectors of the economy all contribute to financial problems. It is not appropriate in our view to make direct investments the primary culprit. We believe that the capital requirements have addressed the issue of direct investments and that supervisory oversight should not be overly concentrated on direct investments but both management and regulators should look at the overall health of an institution considering capital levels, direct investments, construction lending, and all other areas of association activity. We have seen failures occur in every category of investments from single family lending to government bonds to construction lending to direct investments. Risk oriented people can find risk in any category of investment and bad management or changes in economic circumstance can effect many types of investment. We believe the direct investment rule has served a very useful purpose but that subsequent actions of the board have really addressed this area of concern in a broader and more effective sense and that the need for detailed regulations of direct investments has been reduced for associations with improving capital ratios.

Sincerely,

Gary H. Driggs

zs/da

National Association of
State Savings & Loan Supervisors

Voice of the State Chartered System

INFORMATION SERVICES

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October 16, 1986

Ms. Roberta White
Director, Information Services
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

RE: Regulation of Direct Investment by Insured Institutions--Federal Register No. 86-962

Dear Ms. White:

On September 17, 1986, the Federal Home Loan Bank Board published for public comment a proposed rule which would amend its existing regulation governing investments by institutions the accounts of which are insured by the Federal Savings and Loan Insurance Corporation in equity securities, real estate, service corporations, and operating subsidiaries. This proposed amendment to the "direct investment" rule would defer the expiration of the rule from January 1, 1987 to January 1, 1989. The FHLBB has indicated that it is specifically requesting comment on the administrative flexibility of the "direct investment" rule and, moreover, the continued need for the rule in its present form in light of the FHLBB's recent adoption of higher regulatory capital requirements for insured institutions.

The National Association of State Savings & Loan Supervisors views this proposal as of the utmost importance. Specifically, NASS&LS believes that the issue of whether the "direct investment" rule is still necessary in light of the FHLBB's recently promulgated regulation pertaining to the capital requirements of insured institutions deserves the highest level of scrutiny. There is not universal agreement as to the appropriateness of the existing regulation, much less the issue of extending the "sunset" provision for an additional two years. Many believe that the existing regulation was illconceived and hastily put into effect. Others believe that the regulation is essential. As the representative body of the state regulatory arm of our dual system of regulation in the financial institutions area, NASS&LS believes that an issue of this magnitude, which directly impacts NASS&LS' members and moreover the institutions of which they are the primary regulatory authorities, deserves more than a 30-day comment period.

The FHLBB's standard comment period is 60 days. Why, one must ask, does the FHLBB view this proposal as not warranting its standard treatment? 30 days is a wholly insufficient period within which to expect comments from the cross-section of interested parties, the FSLIC, the various regulatory authorities, the insured institutions, the Congress of the United States, and consumers at large who realize the significant and immediate impact of an extension of the "sunset" provision for an additional two years. As the Honorable Doug Barnard, Jr., Chairman of the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations stated in his comment letter dated October 2, 1986, "In the absence of a comprehensive study by the [FHLBB], the rule should be renewed, if at all, only after the most thorough analysis [of] the rule making itself. In these circumstances, extensive comment and comment analysis seem crucial." NASS&LS concurs with this position. Additionally, no significant emperical data has been produced which (1) warrants an extension and (2) in light of this fact, an abbreviated comment period.

In light of the FHLBB's new regulation relative to regulatory capital requirements, which expressly addresses direct investments by insured institutions, NASS&LS must at a minimum respectfully request not an extension, but rather, mere compliance with the FHLBB's own Resolution No. 80-854.

NASS&LS would like to reiterate its support for the FHLBB and its overriding concern for the safety and soundness of the thrift industry and specifically the FSLIC. NASS&LS is second to none in its vigil to see that participants in the thrift industry conduct themselves in a safe and sound manner. However, we again stress our belief that quality supervision rather than excessive regulation will achieve this goal more quickly. NASS&LS once again extends to the FHLBB its offer of support and assistance in whatever way possible to achieve our common goal.

Again, NASS&LS respectfully requests an extension of the public comment period until at least November 16, 1986.

Very truly yours,

The Executive Committee of The
National Association of
State Savings & Loan
Supervisors

By: William M. Drohan
William M. Drohan
Executive Vice President

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October 16, 1986

Office of the Secretariat
Federal Home Loan Bank Board
1700 G. Street, N.W.
Washington, D.C. 20552

Re: Proposed Extension of Direct Investment Regulation (Section 12 C.F.R. 563.9-8)

Dear Sir:

This office serves as legal counsel to a number of savings and loan associations. We would like to provide our views on the matter of the proposed amendment to section 12 C.F.R. 563.9-8 which, if adopted, would extend the operation of this regulation commonly referred to as the Direct Investment Regulation. We believe two circumstances mitigate against further extension of the effect of the regulation.

First, is the regulation which has been adopted to acquire increased capitalization of FSLIC insured institutions (12 C.F.R. 561.13) and which becomes effective on January 1, 1987. Increased capital should be accompanied by increased authority for savings institutions to become competent in investing in direct investments or to diversify in other ways.Innovation is a necessary ingredient to the survival of any business. FSLIC institutions should be permitted to innovate to the extent this represents prudent action.

Admittedly, many savings and loan associations have more competence at residential mortgage lending than in direct investments but this is a result of having significantly more experience in residential mortgage lending. With the gaining of experience in direct investments, these investments should provide an equally safe source of revenue as an alternative to residential mortgage lending when residential mortgage lending is unprofitable or when the amount of funds available for residential mortgage lending far exceeds the requirements of the market. Reliance on a single form of lending played a significant role in the attrition suffered by the savings and

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loan industry during the recent period of high money rates. A sole reliance on residential mortgage lending may, in the future, prove fatal to many savings and loan associations.

Second, it is likely that the Congress will adopt some form of legislation which contains within it a definition of a "qualified thrift lender". In most of this legislation, the bench mark for qualification is that 60% of an institution's investments should be in residential mortgage lending. In the event that an institution meets the requirements to be a qualified thrift lender, we believe this should equate with a discharge of its obligation for FSLIC insurance as well as for its civic responsibility as a financial institution. Thereafter, the remaining 40% of assets should be left to the business judgment of management of financial institutions subject to supervision, where, despite good intentions, management's competence does not equate with management's ambitions. It would be highly inappropriate if the 40% were a matter of mandatory investment selection by a government agency.

For the reasons stated above, it is our view that an extension of the direct investment regulation is not necessary and is not in the long-term interest of the savings and loan industry.

Respectfully submitted,

LEFF & JENSEN

By ______________________
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October 16, 1986

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INFORMATION SERVICES

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Washington, D.C. 20552

RE: Comments in Opposition to Proposed Two-Year Extension of "Regulation on Direct Investment by Insured Institutions" (51 Fed. Reg. 32925)

Dear Ms. White:

Lincoln Savings and Loan Association ("Lincoln"), a California-chartered thrift institution insured by the Federal Savings and Loan Insurance Corporation ("FSLIC"), submits these comments opposing the Federal Home Loan Bank Board's proposed two-year extension of its "Regulation on Direct Investment by Insured Institutions," 12 C.F.R. S563.9-8 ("Direct Investment Regulation").

The Direct Investment Regulation was an ill-conceived and unnecessary regulatory experiment when first proposed by the Board in May, 1984. At that time, Lincoln, among dozens of other interested parties, raised fundamental questions regarding both the absence of any statutory bases for the regulation and the lack of any empirical support for the proposition that the regulation would not do more harm than good.

Two and one-half years later, the Board has not responded adequately to either of these fundamental concerns. Accordingly, Lincoln's comments on the extension of the Direct Investment Regulation suggest first, that the Regulation should not be extended because the Regulation is in excess of the Board's statutory authority and in derogation of the regulatory authority expressly reserved by Congress for the states. Second, Lincoln reviews the existing factual and empirical studies and demonstrates that the necessary

Ms. Roberta White
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evidentiary support for the Direct Investment Regulation is lacking. Finally, Lincoln suggests that the extension of the Direct Investment Regulation is clearly improper in light of recent regulatory developments, especially the revised Net-Worth Regulation, and available, less intrusive alternatives.

Lincoln also requests additional time to submit further studies analyzing the effects of the proposed extension of the Direct Investment Regulation, and an opportunity to make an oral presentation to the Board.

Yours truly,

Mark S. Sauter
Vice President and
General Counsel

MSS/kr

Lincoln Savings and Loan Association's Comments In Opposition To Proposed Extension of Federal Home Loan Bank Board Regulation On Direct Investment By Insured Institutions

Prepared by:

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MEMORANDUM

RE: Proposed Extension of Federal Home Loan Bank Board "Regulation of Direct Investment by Insured Institutions" (51 Fed. Reg. 32925)

DATE: October 17, 1986

This memorandum has been prepared for Lincoln Savings and Loan Association ("Lincoln") to set forth its opposition to the proposed extension of the expiration date of the Federal Home Loan Bank Board's "Regulation of Direct Investment by Insured Institutions," 12 C.F.R. § 563.9-8 (1985). In its September 11, 1986 Notice of Rulemaking, the Board requested interested parties to provide comments on the desirability of extending the regulation for an additional two years, to January 1, 1989. 51 Fed. Reg. 32925 (1986). The Board specifically requested comments on the "administrative flexibility" of the Direct Investment Regulation and on the continued need for the rule "in its present form," in light of the Bank Board's adoption of other regulations, including the so-called "Net Worth" Regulation, 12 C.F.R. § 563.13 (1985).*

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* The Net Worth Regulation is also scheduled to expire on January 1, 1987. On August 15, 1986, the Board adopted a replacement rule, known as the "Regulatory Capital" Regulation, which requires an insured institution to maintain a level of regulatory capital equal to 6 percent of total liabilities, and imposes additional capital requirements based on factors such as the institution's level of direct investment.

The Board should not extend the Direct Investment Regulation, which was outside the scope of its authority when first adopted. After its initial proposal in May, 1984, the Direct Investment Regulation was opposed in more than 200 comments submitted by interested parties. Despite fundamental concerns regarding the Board's legal authority to promulgate an across-the-board regulation intruding so profoundly upon an area of regulation reserved to the States, and significant questions with respect to the adequacy of the factual evidence offered in support of such a rule, the Board adopted the regulation, with some modifications, in January, 1985. In recognition of the controversy generated by the new rule, however, the Board did incorporate a "sunset provision" requiring the regulation automatically to expire on January 1, 1987, absent further Board action. The Board has now taken that action by proposing an extension of the regulation for another two years without addressing the outstanding issues presented by the original adoption of the regulation.

Indeed, the number of important factors relating to the Direct Investment Regulation that the Board has not addressed in seeking to extend the regulation is striking:

o the impact of the regulation on state law and state regulatory schemes;

- the need for the regulation given other less costly means to protect the FSLIC fund, including increased supervisory practices;

- the absence of Board authority to promulgate across the board prospective regulation of savings and loan investments;

- how, if at all, direct investments cause savings and loan failure;

- the costs of precluding direct investment, both to the industry and its customers;

- the extent to which the limitations on direct investment make the industry less competitive and the related costs of the regulation in lost deposits and ultimately lost premiums for the FSLIC fund; and

- the absence of any criteria by which the Board is able to make a non-arbitrary decision to waive the direct investment limits.

The Board's lack of legal authority and factual support for the promulgation of this regulation has not been remedied. The Board must show a clearly defined congressional grant of power permitting it to either preempt state

laws allowing direct investment by state-chartered thrift institutions or to regulate concurrently with state authorities in an area historically policed by the states. The Board could not do this when the Direct Investment Regulation was originally proposed in 1984 and cannot do so today. The necessity of sharing such a grant of authority has become even more significant since the regulation was adopted. The United States Supreme Court has recently examined the federal-state balance in a regulatory context not unlike the dual system of regulation characterizing the savings and loan industry, and it has reaffirmed a fundamental rule that a federal administrative agency cannot enter an area of regulation traditionally reserved to the States absent a clearly defined statement of congressional authority. Bowen v. American Hospital Ass'n, 106 S.Ct. 2101, 2121 & n.33 (1986).

With respect to the issue of factual support, the Board must resolve a number of factual concerns before its restriction on direct investments can be justified. First, the Board must establish causation -- the Board must show that direct investments cause thrift failures. Second, it must show the relationship between the cost of thrift failures and the level of direct investment. Third, it must show that the costs to the FSLIC fund cannot be avoided by more vigorous use of the Board's lawful enforcement power -- the power to conduct cease-and-desist and insurance termination proceedings pursuant to 12 U.S.C. § 1730. Fourth, it must show that the

costs avoided by the direct investment rule exceed the additional fund premiums which would be paid by thrift institutions that could prosper as a result of direct investments,* and the savings to the fund from marginal institutions which are put on a sounder financial footing by direct investments.

The Board has not shown any of these necessary facts. It did not demonstrate them when it first adopted the Direct Investment Regulation, and it failed to correct any of these deficiencies in its September 11, 1986 Notice of Rulemaking. In its September Notice, the Board offered three new items in support of the Direct Investment Regulation. First, the Board cited a recent empirical study -- funded by the Board's Office of Policy and Economic Research -- which purportedly showed that higher levels of direct investment increase FSLIC costs of resolving thrift failures. Second, the Board asserted that the waiver provision of the Direct Investment Regulation affords sufficient flexibility to permit well-managed institutions to exceed the supervisory thresholds established by the rule. Third, the Board referred to a 1985 report by the House Committee on Government

* Profits from direct investment do not automatically translate into higher fund premiums. However, because more profitable institutions attract more depositors due to their ability to pay higher interest on accounts, those institutions ultimately pay higher fund premiums based upon the increased level of deposits.

Operations which termed the Direct Investment Regulation "an appropriate and necessary restriction." See H.R. Rep. No. 358, 99th Cong., 1st Sess. 14 (Nov. 5, 1985).

None of these new items supports extension of the Direct Investment Regulation, because none addresses the fundamental flaws inherent in the regulation's adoption by the Board. Before dealing with the new items, it is necessary first to address those fundamental flaws which have affected the regulation from the outset and which would make its extension unlawful.

I. THE DIRECT INVESTMENT REGULATION IS UNLAWFUL BECAUSE IT IS BEYOND THE BOARD'S STATUTORY AUTHORITY.

When first adopted by the Board, the Direct Investment Regulation was unlawful for two reasons. First, the Board had no statutory authority to issue a regulation that preempted or supplanted the enactments of state legislatures authorizing unlimited or less restricted direct investment by thrift institutions operating pursuant to state charters. Second, the Board lacked the statutory authority to issue an across-the-board, substantive regulation governing thrift institution conduct. No factual showing could overcome either of these infirmities. Because of them, the Direct Investment Regulation was improper when adopted and should not be extended. These two separate and independent defects

in the Board's authority to adopt the Direct Investment Regulation will be separately discussed.

A. Contrary to Congressional Intent, the Direct Investment Regulation Undermines the Dual System of Thrift Regulation.

Although thrift institutions have been operating pursuant to state charters for more than 130 years, federal involvement in the savings and loan industry is a much more recent phenomenon. Beginning in 1932, with the adoption of the Federal Home Loan Bank Act, ch. 552, 47 Stat. 725, codified at 12 U.S.C. §§ 1421-49, through the Home Owners' Loan Act of 1933, ch. 64, 48 Stat. 128, codified at 12 U.S.C. §§ 1461-70, and the 1934 National Housing Act, Title IV, ch. 847, 48 Stat. 1255, codified at 12 U.S.C. §§ 1724-30, Congress created the basic framework for a dual system of savings and loan regulation in which federal authority over state-chartered thrift institutions was permitted on a case-by-case basis only to the extent necessary to protect the federal thrift deposit insurance fund administered by the FSLIC.*

* There is a clear distinction between the Board's role in the Federal Home Loan Bank System and its role regarding the federal thrift deposit insurance fund of the FSLIC. The Board's powers with respect to the latter are more narrowly drawn; its only goal is to protect the insurance fund. As a result, the Board must clearly establish that actions to be justified using statutory authority relating to the FSLIC do in fact protect the insurance fund. Compare 12 U.S.C. § 1425a(a) with 12 U.S.C. § 1725(a).

State-chartered institutions that obtain federal deposit insurance must subject themselves to "such examinations as the [Board] shall deem necessary . . . ." 12 U.S.C. § 1726(b). This provision, added by the National Housing Act, was the first and most substantial grant of federal supervisory authority over state-chartered, federally insured savings and loan associations.

Other than the right to conduct periodic examinations, the regulatory authority granted to the Board in the National Housing Act was carefully drawn to be as narrow as possible. In contrast to the Board's authority over federally chartered and insured institutions, there was no general grant of supervisory or rulemaking authority that would allow the Board to oversee the operations of insured institutions chartered under state laws or otherwise issue prospective regulations governing their operations. Cf. 12 U.S.C. § 1464(a) (granting Board plenary authority over the "operation" and "regulation" of federally chartered savings and loan associations).

In 1954, the power of the Board was expanded by Congress to allow the agency to act on a case-by-case basis and terminate FSLIC insurance if any insured institution engaged in "unsafe or unsound" practices. However, the procedures imposed by the statute required the Board to give state regulatory authorities notice of the problem and an

opportunity to correct it before the Board could take any action. See Title V, § 501(3), 68 Stat. 633, codified at 12 U.S.C. § 1730. According to the legislative history, the requirement that the Board initially defer to the state regulatory authority was "designed to assure that the [federal law] would not impair the supervisory authority of the state or local bodies over insured institutions . . . ." Conference Rep. No. 2271, 83d Cong., 2d Sess. 84 (1954).

Congress continued to mandate deference to state authority when it again modified the enforcement powers of the Board in 1966. The Financial Institutions Supervisory Act of 1966, Pub. L. No. 89-695, § 102(a), 80 Stat. 1028 ("the 1966 Act"), for the first time granted the Board the authority to institute, on a case-by-case basis, cease-and-desist proceedings directly against a state-chartered, federally insured savings and loan association upon a finding that the institution in question was engaging in "unsafe or unsound" practices.

The legislative history of this amendment again demonstrates that the Board's enforcement power was not intended to override the authority of the States, and that the primary regulatory power over state-chartered institutions was to be left where it had always rested -- with the States. The Senate Report relating to the 1966 Act makes this point explicitly:

"The committee did not wish to take any action which would do violence to the balance between State and Federal functions and responsibilities which underlies the dual banking system and the dual savings and loan system. On the contrary, the committee was in full agreement with the statement made by the [committee] chairman in his remarks before the National Association of Supervisors of State Banks at Williamsburg, Va., quoted in the hearings 'The duties and powers of the Federal Reserve Board and the FDIC are broad and sweeping. They must be in order to carry out their functions. But neither they nor the State member and insured banks nor the State bank supervisors should ever forget for one moment that the State banks are chartered by the States, and are operated under State laws, and are responsible first and foremost to the officials of the States which created them.'"

S. Rep. No. 1482, 89th Cong., 2d Sess. (1966), reprinted in [1966] U.S. Code Cong. & Ad. News 3532, 3538 (emphasis added).* The Senate Report further stressed that "the bill emphasizes the role of the State chartering and supervisory authorities, and in no way lessens the status of these State authorities." Id. at 3539 (emphasis added).**

* The legislative history of the Act contains references to the Federal Reserve Board and FDIC because the Act dealt with the supervisory authority of all of the "Federal agencies supervising banks and savings and loan associations -- the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board . . . ." S Rep. No. 1482, reprinted in [1966] U.S. Code Cong. & Ad. News 3532, 3533.

** At the hearing on the bill, Chairman Horne stated:

"We have also been conscious, in drafting this bill, that under our dual system the primary responsibility for supervision of State-chartered financial institutions lies on the State authorities. We have no

(Footnote continued on next page)

As recently as 1982, Congress reaffirmed its commitment to the dual system of savings and loan regulation. Pursuant to section 123 of the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469, the FHLBB was permitted to authorize, on an emergency basis, acquisition of a state-chartered, federally insured institution by an institution in another State, based on a finding that severe financial conditions were present and such an acquisition would lessen the risk of potential loss to the FSLIC. 12 U.S.C. § 1730a(m). Before the FHLBB was allowed to make such a determination, however, it was required to consult with the state regulatory body having authority over the institution to be acquired, thus providing an opportunity for the affected state regulators to object to the acquisition. Id., § 1730a(m)(1)(B). That Congress determined to provide a role for the States in these circumstances, where the risk to the federal insurance fund was both imminent and substantial,

(Footnote continued from previous page)

> quarrel with that concept . . . . Our objective is quite simply an effective backup capacity when needed, and hence we do not object to the amendments adopted by the Senate to assure State authorities of notice and opportunity for action or objection on their part before we commence a proceeding involving an insured State institution."

Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 before the Committee on Banking and Currency, 89th Cong., 2d Sess. (1966) (emphasis added).

demonstrates Congress' continued commitment to maintaining the dual system of regulation.

Congress' concern in ensuring the primary role of the States in regulating the savings and loan associations chartered by them leaves little room for doubt that the Board's promulgation of a regulation going to the very heart of state authority -- the power to determine how state-chartered thrift institutions invest the funds deposited with them -- went beyond the scope of permissible administrative action authorized by the Congress. The Direct Investment Regulation intrudes upon state respohsibilities in one of two ways, either of which is demonstrably outside the scope of Board's authority. First, the Direct Investment Regulation preempts the laws of States which allow levels of direct investment for their state-chartered savings and loan institutions that exceed 10 percent of assets.* But, for the reasons stated above, the Board cannot remotely demonstrate that Congress explicitly or implicitly intended that the Board would have authority to preempt state law judgments about levels of direct investment of state-chartered institutions. See Jones v. Rath Packing Co., 430 U.S. 519 (1977). Louisiana Public Service Comm'n v. FCC, 106 S. Ct. 1890, 1901 (1986)("an agency literally has no power to act, let

* California, for example, grants broad authority to make investments in real estate, Cal. Financial Code § 7300, as well as other types of direct investment, including equity securities, see Cal. Financial Code § 7250, subject, of course, to strict state supervision.

alone pre-empt the validly enacted legislation of a soverign state, unless and until Congress confers power upon it.");

Second, in the absence of a clear congressional statement authorizing the Board to regulate concurrently an area of savings and loan association operations which has been solely within the province of the States, the Board is powerless to engage in such concurrent regulation. This fundamental rule has recently been reaffirmed in the Supreme Court's decision in Bowen, supra, 106 S.Ct. at 2121 (1986):

> "'[W]e must assume that the implications and limitations of our federal system constitute a major premise of all congressional legislation. . . .' United States v. Gambling Devices, 346 U.S. 441, 450 . . . (1953) (opinion of Jackson, J.). Congress therefore 'will not be deemed to have significantly changed the federal-state balance,' United States v. Bass, 404 U.S. 336, 349 . . . (1971) -- or to have authorized its delegates to do so -- 'unless otherwise the purpose of the Act would be defeated', Trade Comm'n v. Bunte Bros., 312 U.S. 349, 351 . . . (1941)."*

* In support of its holding, the Court cited several decisions holding that intrusion into historic areas of state regulation by concurrent federal regulation may only be justified by a clear statement of congressional intent. See, e.g., Heublein, Inc. v. South Carolina Tax Comm'n, 409 U.S. 275, 281-82 (1972); Davies Warehouse Co. v. Bowles, 321 U.S. 144, 152 (1944) ("Where Congress has not clearly indicated a purpose to precipitate conflict [between federal agencies and state authority], we should be reluctant to do so by decision"); Penn Dairies, Inc. v. Milk Control Comm'n, 318 U.S. 261, 275 (1943) ("An unexpressed purpose of Congress to set aside statutes of the States regulating their internal affairs is not lightly to be inferred and ought not to be implied where the legislative command, read in the light of its history, remains ambiguous"); Apex Hosiery Co. v. Leader, 310 U.S. 469, 513 (1940) ("An intention to disturb the balance [between state and national governments] is not lightly to be imputed to Congress"). See Bowen, supra, 106 S.Ct. at 2121 n.33.

The Direct Investment Regulation represented a major departure from the carefully constructed balance between federal and state regulatory authority over the savings and loan industry. The Board simply overstepped the bounds of its authority. In nullifying the determinations of state legislatures and regulators to permit the institutions they chartered to engage in direct investment, the Board completely ignored Congress' determination to leave certain areas to the States. What the Supreme Court declared in striking down a similar attempt by the FCC through rulemaking to supersede state regulation which Congress had intended to preserve applies directly to the FHLBB's proposed regulation:

> "[W]e simply cannot accept an argument that the FCC may nevertheless take action which it thinks will best effectuate a federal policy. An agency may not confer upon itself power. To permit an agency to expand its power in the face of a congressional limitation on its jurisdiction would be to grant to the agency power to override Congress. This we are both unwilling and unable to do.

Louisiana Public Service Comm'n v. FCC, 106 S.Ct. 1901-1902.

The Board's action was unlawful when first proposed in 1984; it remains unlawful today. Allowing the Direct Investment Regulation to expire will restore the proper balance between federal and state regulators.

B. The Board Cannot Lawfully Promulgate Across-the-Board Regulations Restricting Direct Investments.

When the Board initially proposed the Direct Investment Regulation, it relied entirely upon 12 U.S.C. § 1730 as statutory authority for the new rule. Following the receipt of numerous comments suggesting that the Board lacked statutory authority to promulgate the regulation, the Board stated in its notice reproposing the direct investment rule, 49 Fed. Reg. 48743, 48745-46 (1984), that 12 U.S.C. §§ 1424(a), 1437(a) and 1725(a) provided "additional authority" for the Board's power to regulate the direct investments of state-chartered institutions. As is shown below, none of these statutory provisions, either individually or collectively, supports the Board's position, because none provides a general, prospective grant of rulemaking authority over the operations of state-chartered savings and loan associations.

1. Section 1730

Section 1730, upon which the Board primarily relies for its authority to promulgate the direct investment rule, contains the termination of insurance and enforcement provisions of the National Housing Act. In adopting the final version of the Direct Investment Regulation, the Board pointed to Section 1730's grant of authority to institute cease-and-desist or termination proceedings to argue that

such authority to prevent "unsafe or unsound practices" necessarily "encompass[ed] the less drastic power to prevent or unsound practices [sic] through regulations such as the direct investment rule." 50 Fed. Reg. 6914 (1985). But across-the-board regulations are hardly a "less drastic power." Instead, they constitute enormous federal interference in the business activities of all state-chartered, federally insured savings and loan institutions. Moreover, close examination of the language, structure and legislative history of Section 1730 fails to support the Board's position.

The plain language of the cease-and-desist provision of Section 1730 provides:

> "If, in the opinion of the Corporation, any insured institution or any institution any of the accounts of which are insured is engaging or has engaged, or the Corporation has reasonable cause to believe that the institution is about to engage, in an unsafe or unsound practice in conducting the business of such institution, or is violating or has violated, or the Corporation has reasonable cause to believe that the institution is about to violate, a law, rule, or regulation, or any condition imposed in writing by the Corporation in connection with the granting of any application or other request by the institution . . ., the Corporation may issue and serve upon the institution a notice of charges in respect thereof . . . and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist therefrom should issue against the institution."

12 U.S.C. § 1730(e). There is no language in this section from which the Board could reasonably derive authority to

promulgate across-the-board, prospective restrictions on any type of investment which would apply to <u>all</u> institutions. Indeed, the only authority to promulgate any rules or regulation provided by Section 1730 appears in the following passage (12 U.S.C. § 1730(m)(3)):

> "<u>In the course of or in connection with any proceeding under this section</u>, the [Board] . . . shall have power to administer oaths and affirmations, to take or cause to be taken depositions, and to issue, revoke, quash, or modify subpoenas and subpoenas duces tecum; and <u>the [Board] is empowered to make rules and regulations with respect to any such proceedings</u>." (emphasis added)

In short, there is not the slightest suggestion in the language or legislative history of Section 1730 that the Board is empowered to deal with potential "unsafe and unsound" practices through any means other than the adjudicative proceedings provided for in the statute.*

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* In <u>FAIC Securities, Inc.</u> v. <u>United States</u>, 595 F. Supp. 73 (D.D.C. 1984), <u>aff'd</u>, 768 F.2d 352 (D.C. Cir. 1985), the district court considered whether the Board had the statutory authority under Section 1730 to issue regulations limiting the insurance on "brokered" deposits. The court held that the authority granted in Section 1730 to seek to halt "unsafe and unsound" practices in an individualized, adjudicative proceeding did not include the authority to issue general regulations addressing the same conduct. According to the court, the provisions of Section 1730 (595 F. Supp. at 78 n.7):

> "relate to specific enforcement actions brought against individual banks . . . . [T]he power to prescribe regulations which 'effectuate the purposes' of those provisions clearly does not contemplate across-the-board regulations of the type at issue here."

(Footnote continued on following page)

As noted previously, the Board withdrew from its initial position that Section 1730 alone provided sufficient statutory authority for the direct investment regulation. See 49 Fed. Reg. 48745. However, the "additional authority" cited by the Board -- Sections 1725(a), 1437(a) and 1424(a) -- added nothing to its position.

2. Section 1725(a)

Section 1725(a), which was added by Title IV of the National Housing Act, § 402, provides that:

> "There is hereby created a Federal Savings and Loan Insurance Corporation . . . which shall insure the accounts of institutions eligible for insurance as hereinafter provided, and shall be under the direction of [the Federal Home Loan Bank Board] and operated by it under such bylaws, rules, and regulations as it may prescribe for carrying out the purposes of this title [Title IV of the National Housing Act]."

12 U.S.C. § 1725(a) (emphasis added). The plain language of the statute limits the "bylaws, rules and regulations"

(Footnote continued from previous page)

The Board's reliance on Independent Bankers Ass'n v. Heiman, 613 F.2d 1164 (D.C. Cir. 1979), as support for its authority to promulgate the Direct Investment Regulation, see 49 Fed. Reg. 48746 (1984), was also misplaced. That case concerned the authority of the Office of the Comptroller of the Currency to issue regulations defining certain "unsafe or unsound" practices. In upholding the regulation, the court relied on the Comptroller's statutory authority to issue broad, substantive regulations and pervasively regulate national banks. The FHLBB has no such authority over state-chartered institutions.

promulgated under this section to a narrow subject matter -- the "operat[ion] by [the Bank Board]" of the FSLIC. There is no basis in the language of the statute to expand a limited power to promulgate internal "housekeeping" rules and regulations into a grant of authority substantively to regulate insured institutions.

Such a reading is also inconsistent with the structure of the statute. The origin of Section 1725 -- section 402 of Title IV of the National Housing Act, entitled "Creation of Federal Savings and Loan Insurance Corporation" -- was the first substantive section of the Act. In addition to the language quoted above, the section contained a detailed description of the structure of the newly-created FSLIC, including such items as capitalization of the FSLIC fund, accounting and reporting requirements, and the location of the fund's principal office. <u>All of these relate to the FSLIC and not to the institutions that it insures</u>. It is in subsequent sections of the National Housing Act that Congress defined the duties and authority of the FSLIC and the Bank Board with respect to savings and loan institutions. Accordingly, reliance upon Section 1725 to provide the authority to issue substantive regulations relating to insured institutions is misplaced.

3. Section 1437(a)

The next provision cited by the Board, Section 1437(a), specifically states that the Board's authority is limited to "such rules, regulations, and orders as shall be necessary from time to time for carrying out the purposes of the provisions of this Act." 12 U.S.C. § 1437(a) (emphasis added). The "provisions of this Act" -- i.e., the Federal Home Loan Bank Act -- have nothing to do with the federal thrift deposit insurance fund. They concern only the creation, operation and management of the Federal Home Loan Banks.* The Supreme Court's decision in Laurens Federal Savings & Loan Assn's v. South Carolina Tax Comm'n, 365 U.S. 517, 522 (1961), identified the "purposes" of the statute:

> "[The act] set up a system of federally chartered Home Loan Banks for the purpose, as stated in the House and Senate Committee Reports, of placing 'long-term funds in the hands of local institutions' in order to alleviate the pressing need of home owners for 'low-cost, long-term, installment mortgage money' and to 'decrease costs of mortgage money' with a resulting benefit to home ownership in the form of lower costs and more liberal loans."

Similarly, in Association of Data Processing Service Organizations, Inc. v. Federal Home Loan Bank Board, 568 F.2d 478, 486 (6th Cir. 1977), the Sixth Circuit defined the power

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* It is striking that the Board attempts to rely on Section 1437(a) to support a regulation that purports to protect the FSLIC, when that agency had not even been created at the time Section 1437(a) was enacted.

granted the Bank Board under Section 1437(a) as "limited to basically one important function" -- establishing the Federal Home Loan Banks and ensuring that funds are available for local institutions which make loans to home buyers. Because statutes relating to the Federal Home Loan Bank system have nothing whatsoever to do with the federal thrift deposit insurance fund, there was no basis for the Board's attempt to use the limited power granted by Section 1437(a) to adopt regulations restricting direct investments.

4. Section 1424(a)

The Board's attempt to rely upon Section 1424(a), which is also a provision of the Federal Home Loan Bank Act, suffers from the same infirmity. Section 1424(a) simply sets forth the eligibility requirements for membership in a Federal Home Loan Bank. It makes no mention of, and bears no relation to, any activities of the Board relating to thrift deposit insurance. Section 1424(a) provides that:

> "Any building and loan association . . . shall be eligible to become a member of, or a nonmember borrower of, a Federal Home Loan Bank if such institution . . . is subject to inspection and regulation under the banking laws, or under similar laws, of [a] State, or of the United States. . . ."

The plain language of the statute simply states that an institution seeking membership in a Federal Home Loan Bank must be subject to state or federal regulation.

It does not provide any authority for the Board to create substantive regulations.

In sum, the Board lacked the statutory authority to issue the Direct Investment Regulation. Absent a clear congressional statement permitting the Board directly to regulate the investment practices of state-chartered thrift institutions, the Board did not have the power to invade this area of traditional state regulatory authority. Furthermore, absent a grant of substantive rulemaking power, the Board was not permitted to create such authority from statutes providing for individualized cease-and-desist proceedings.

Because the Board lacked the statutory authority initially to adopt the Direct Investment Regulation, it does not have the power to extend that regulation. Accordingly, the Board should permit the regulation to expire on January 1, 1987. Moreover, even if the Board had the statutory authority, it has not made, and cannot make, the factual showings necessary to support the Direct Investment Regulation.

II. THE BANK BOARD HAS NOT PROVIDED SUFFICIENT FACTS TO SUPPORT THE DIRECT INVESTMENT REGULATION.

As the Board itself has recognized, the "complexity of the problems" which the Board sought to address with the Direct Investment Regulation is such that assessment of the rule's costs and benefits is especially difficult. Indeed,

this was the reason that the regulation was adopted for a two-year trial period. 51 Fed. Reg. 32926 (1986). Unfortunately, the Board has never dealt with those complex problems in a satisfactory fashion. Thus, the Regulation has never had the factual basis required to support its adoption.

As the Supreme Court noted in Bowen (106 S.Ct. at 2121-22):

> "The need for a proper evidentiary basis for agency action is especially acute . . . [where] Congress has failed to indicate, either in the statute or in the legislative history, that it envisioned federal . . . [participation in an area] traditionally entrusted to state governance.
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> * * * *
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> "'[T]he propriety of the exertion of the authority must be tested by its relation to the purpose of the [statutory] grant and with suitable regard to the principle that whenever the federal power is exerted within what would otherwise be the domain of state power, the justification of the exercise of the federal power must clearly appear'. . . . That is, 'it must appear that there are findings, supported by evidence, of the essential facts . . . which would justify . . . [the agency's] conclusion.'" (citations omitted)

The Board's promulgation of the Direct Investment Regulation was precisely the type of federal administrative action that the Supreme Court was discussing in Bowen. The Board was obligated to show that it had evaluated the impact of its action on the regulatory regimes of the various states; that there was a relationship between direct investment and thrift failures; that those failures imposed costs upon the FSLIC;

that those failures and costs could not have been avoided through a less intrusive means, such as more vigorous use of Section 1730 cease-and-desist and termination proceedings; and that the costs of direct investment were not outweighed by the benefits of such investment to the savings and loan industry and the FSLIC. The Board has never made such a showing.

Most strikingly, the Board has never attempted to analyze the nature and effect of the laws of the 50 States on this issue, and to explain why there is a problem with the administration of those laws which justifies broad federal involvement.

In the May 16, 1984 Notice of Rulemaking in which the Direct Investment Regulation was first proposed, the Board offered minimal factual support to show the link between direct investment and thrift failures. See 49 Fed. Reg. 20719-20 (1984). Indeed, the only data offered was an anecdotal reference to losses associated with the development of the I-30 corridor outside of Dallas, Texas. Id.

The paucity of supporting data offered by the Board was criticized by many of the interested parties offering comments on the proposed rule. Those parties submitted empirical studies, the most significant of which had been prepared by Professor George Benston of the University of

Rochester, that showed the lack of a relationship between direct investment and thrift failures. Attempting to meet the factual challenge posed by Professor Benston's results, the Board offered additional data supporting its position when the Direct Investment Regulation was reproposed in December, 1984. See 49 Fed. Reg. 48747-50 (1984).

All that the additional data provided by the Board demonstrated was the greater variability of return associated with certain categories of direct investments. The data did not show that this variability, which the Board accepted as a proxy for the degree of risk associated with such investments, accounted for the failure of thrift institutions making such investments. For that necessary step, the Board reverted to its "supervisory experience" -- i.e., anecdotal data of questionable application to the savings and loan industry as a whole.

The Board rejected Professor Benston's findings "because of material methodological and analytical defects." Id. at 48748. Those "defects" purportedly included an insufficiently large sample, differences between Professor Benston's and the Board's definitions of direct investment, and a failure to perform tests of statistical significance. However, the Board's criticisms of Professor Benston's study were not valid. Moreover, in dismissing Professor Benston's work, the Board failed to note that his study was the only

analysis available that directly dealt with the nature of the relationship between direct investment and thrift failure.

Whether or not Professor Benston's study was dispositive on the factual issue that the Board had to resolve in order to adopt the Direct Investment Regulation in a lawful manner, it is clear that his work, and the work of other experts in the field, raised substantial doubts as to the relationship between direct investment and thrift failures.

Indeed, even one of the Board's own experts on the causes of savings and loan failures, and the related costs to the FSLIC has admitted that the Direct Investment Regulation is unnecessary, if not harmful. In a letter to George P. Rutland, CEO of California Federal Savings and Loan Association, Mr. Scott Taylor, who had at the time "been in charge of liquidating failed FSLIC-insured institutions" for over two years, stated: "I can see no basis to claim that direct investment authority is a cause of increased failure or a risk to the FSLIC." Instead, according to Mr. Taylor, failure to "prevent and deter wrongdoing, crime, fraud and incompetence <u>will</u> cause increased failures regardless of legal limits on investments. It is difficult to see the wisdom of barring the great majority of sound, well-managed savings institutions from safe and profitable business simply because regulators fail to prevent or deter others from

crime." Letter to George P. Rutland from Scott Taylor (November 29, 1985).

Given the substantial doubts regarding the burdens and benefits of the rule, the Board should not have adopted the Direct Investment Regulation. Moreover, the Board should not extend the regulation without a much more detailed analysis.

In its September 11, 1986 Notice of Rulemaking the Board offered only one piece of additional empirical evidence to support extension of the Direct Investment Regulation. That evidence was a recent study performed by Messrs. Barth, Brumbaugh and Sauerhaft and entitled "Failure Costs of Government-Regulated Financial Forms: The Case of Thrift Institutions." Focusing on 324 failed thrift institutions, the study analyzed the relationship between the cost of thrift failures to the FSLIC and various characteristics of the failed savings and loan associations. According to the Board, the results of this study show that thrift institutions which engage in significant direct investment activities impose greater costs on the FSLIC when they fail. Limitations on direct investment thus are deemed necessary to protect the federal thrift deposit insurance fund.

The Board-cited study does not support the proposed extension of the Regulation.* First, like prior analyses cited by the Board, the Barth, Brumbaugh and Sauerhaft study does not show that direct investment causes thrift institutions to fail. In order to provide the information necessary to establish such a relationship, a study must include both failed and healthy thrift institutions. Because the Board-cited study does not include healthy institutions, it is of no value in this regard.

The authors of the study cited by the Board have performed two others which do focus on the issue of causation between direct investment and thrift failure. The first of these, "Thrift Institution Failures: Causes and Policy Issues," was published by the Federal Reserve Bank of Chicago in 1985; it thus has been available to the Board for some period of time. The second study, "Thrift-Institution Failures: Estimating the Regulator's Closure Rule," has been available for several months.

Both of these other studies include healthy and failed thrifts; therefore, they are able to shed light on the relationship between direct investment and thrift failures.

* Attached as Exhibit A to this memorandum is the affidavit of Professor George Kaufman of Loyola University in Chicago. Professor Kaufman, a noted expert in the thrift regulation field, has examined the Barth, Baumbaugh and Sauerhaft study and the Board's use of that work to support extension of the Direct Investment Regulation. Professor Kaufman concludes that the Board's attempt to use the study is inappro and therefore does not support the regulation.

Both studies show, as did the work of Professor Benston,* that direct investment has no causal relationship to thrift failure.

The Board's selective citation of empirical studies is disturbing. At least four different studies -- two by the very same authors as the study that the Board does cite -- show the lack of a causal link between direct investment and thrift failures. All were available when the September 11, 1986 Notice seeking to extend the Direct Investment Regulation was issued. However, the Board chose to ignore all four and instead cite another study which does not even address the basic factual issue that must be addressed for the Direct Investment Regulation to have any factual support.

Moreover, even the fashion in which the Board employs the study that it does cite is inappropriate. The results of the Board-cited study do show a statistically significant relationship between the level of a failed thrift's direct investment and the cost to the FSLIC of resolving that failure. However, the results show an even

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* Professor Benston has performed another study on this issue which has just become available. That work, entitled An Analysis of the Causes of Savings and Loan Association Failures (New York University Press 1986), reaches the same conclusion as his prior analyses -- namely, that direct investment has no causal link to thrift failures.

stronger relationship between FSLIC costs and the period of time that passes before the Board acts to close an insolvent thrift. If the Board acted more quickly in this regard, the Board-cited study suggests that FSLIC costs would be dramatically reduced. However, the Board does not even mention this fact.

There is an interrelationship between the time an insolvent thrift is allowed to operate and the level and quality of its direct investments. Once it becomes insolvent, a thrift institution is living on borrowed time and borrowed money (in this case, Federal Home Loan Bank advances). In an attempt to obtain sufficient investment return to improve the thrift's financial situation, its management is likely to undertake more risky investments, including direct investments of questionable quality. When the thrift is finally closed, the FSLIC must absorb the costs of these eleventh-hour direct investments. Had the Board closed the thrift more quickly, the risky direct investments may not have been made, and no relationship would be discernable.

The benefits of the Direct Investment Regulation remain unproved. However, the rule's drawbacks -- the profits denied well-managed savings and loan associations such as Lincoln, and the resulting delay in needed recapitalization of the thrift industry -- are undeniable. The Board attempts to minimize these drawbacks by focusing upon the

"administrative flexibility" afforded by the regulation's waiver provision. However, the waiver provision cannot save the Direct Investment Regulation, particularly as it has been put into effect by the Board.

In its September 11, 1986 Notice of Rulemaking, the Board states that only 14 percent of the waiver applications upon which the Board has taken action have been denied. 51 Fed. Reg. 32926 (1986). In fact, if one includes the number of waiver applications that have been withdrawn, the number of cases where waivers have not been obtained rises to 39 percent of the total. Although the Board may argue that granting more than half of the waiver applications received demonstrates the limited effects of the Direct Investment Regulation on appropriate thrift institutions, such an argument ignores the number of institutions which may have simply decided to forego direct investments authorized by state law simply to avoid the administrative difficulties inherent in any approval process.* Given the delays in obtaining such waivers, it it highly likely that this has occurred. In any event, the Board had a duty to evaluate this issue, too, before it extends the Regulation. Moreover, the Board's assertion ignores the fact that in certain instances, the Board has arbitrarily denied waivers. This was Lincoln's experience in the Spring of 1985, when it

* The Board's statistic also ignores the substantial number of requests for waiver that are pending at the present time.

sought, and was denied, a waiver from its Principal Supervisory Agent and the Board.

III. EXTENSION OF THE DIRECT INVESTMENT REGULATION IS UNNECESSARY IN LIGHT OF AVAILABLE ALTERNATIVES.

Although extension of the expiration date of the Direct Investment Regulation would be improper because of the Board's lack of statutory authority and factual support, it is also unnecessary in light of the available alternatives. Foremost among these is increased use by the Board of the cease-and-desist and insurance termination powers provided pursuant to Section 1730. Such activity is unquestionably within the statutory authority of the Board. Moreover, because it focuses on the individual thrift institutions which pose clear, imminent threats of loss to the FSLIC, Section 1730 enforcement avoids imposing broader restrictions on savings and loan institutions which are well-managed and whose ability to make more profitable direct investments ultimately will lead to additional payments into the federal thrift deposit insurance fund.

More vigorous enforcement by the Board is supported by the Barth, Brumbaugh and Sauerhaft study which the Board cited in its September 11, 1986 Notice of Rulemaking. As noted above, that study suggests that the more quickly the

Board acts to resolve individual thrifts' problems, the lower the costs to the FSLIC.*

A less desirable alternative -- but one clearly preferable to adopted Direct Investment Regulation -- is continuation of the newly adopted Net Worth Regulation.** Although there is a significant doubt that the Board has statutory authority to adopt across-the-board regulations, if such authority exists, the Net Worth Regulation is a much more appropriate exercise of such power than the Direct Investment Regulation. The new Net Worth Regulation, which was adopted on September 22, 1986, requires insured institutions to maintain additional levels of capital for direct investments. This additional capital requirement creates a cushion designed to protect the FSLIC should the thrift fail. Thus, the new capital requirement obviates the need for a flat restriction or direct investments.

Lincoln currently maintains a level of net worth far in excess of the minimum required by the Board. There is no question of Lincoln's solvency; it poses no threat to the federal deposit insurance fund. Under the laws of California, the State granting Lincoln's charter, Lincoln

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* This approach has been supported by Board officials. See Letter from Scott Taylor, Federal Home Loan Bank Board, to George P. Rutland, California Federal Savings and Loan Association, dated November 19, 1985 (attached as Exhibit B).

** 51 Fed. Reg. 33565 (September 22, 1986).

could engage in direct investment beyond the 10 percent limit of the Rule. With the Net Worth Regulation in place, Lincoln would be able to make the direct investments authorized by state law.

CONCLUSION

As noted previously, in its September 11, 1986 Notice of Rulemaking, the Board refers to a 1985 congressional committee report discussing the Direct Investment Regulation and terming it "an appropriate and necessary restriction." 51 Fed. Reg. 32926 (1986). Reviewing the House Report in its totality, one finds, however, that it provides a most effective summary of the points which argue against extension of the Direct Investment Regulation (H.R. Rep. No. 358, 99th Cong., 1st Sess. 13, 15-17):

> "Notwithstanding the increased rash of failures, the committee finds it reasonable to expect that the higher profits among the majority of the institutions making direct investments should far exceed the losses among the unsuccessful ones because direct investment is a highly profitable activity. For this reason, it would appear desirable to encourage controlled direct investment expansion, in spite of the prospect of increased failures, because of the contribution it should make to the profitability of the thrift industry as a whole and its needed recapitalization.
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> "Decreased regulation of investment constraints in federally insured savings and loan institutions, including those relating to direct real estate investments, is . . . a desirable

long-run objective, because prudent use of broad-ended investment authority can enhance the profitability of the industry and contribute to its recapitalization."

* * * *

"The long-term desirability of encouraging prudent risk taking suggests a presumption against a system of prior Federal restraints as long as thrift failures do not threaten the insurance fund or the stability of the system. Specific new evidence will be needed if this presumption is to be overridden in the future.

* * * *

"Before engaging in rulemaking to extend the direct investment rule the Bank Board should conduct new and comprehensive empirical studies of thrifts; operating experience with direct investments in the period following implementation of the net worth and ADC [acquisition, development, and construction] loan accounting rules."

As the House Report notes, the Board has failed to provide the empirical evidence needed to support extension of the Direct Investment Regulation.* The Board has not

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* In a letter to Board Chairman Gray, Congressman Barnard, the Chairman of the House Subcommittee on Commerce: Consumer, and Monetary Affairs that prepared the Report, states

> "We could not have expressed more clearly [in the Report] . . . that our approval [of the Direct Investment Regulation] was based in large measure on the temporary nature of the rule and on the assumption that the Board would continue to examine the factual evidence and abstract analysis on which the rule was founded . . . I note with disappointment, therefore, that the notice publishing the proposed extention of the rule references only one new study, a study that cannot possibly [be] considered comprehensive' in the sense in which the Committee used the term."

(Footnote continued on following page)

shown that direct investment causes thrift failures -- because it does not. The Board has not shown that direct investment harms the savings and loan industry (including the FSLIC) -- because it does not. The Board has not shown that more vigorous Section 1730 enforcement is not a better way to limit the costs of thrift failures -- because it is. Having failed to make the factual showing necessary to support restrictions on direct investment, and in light of the serious concerns regarding the lack of statutory authority to issue the Direct Investment Regulation, the Board should allow that regulation to expire.

(Footnote continued from previous page)

Based on the Board's failure to provide adequate empirical support for the Rule, Congressman Barnard requested that the Board expand the comment period 60 days to allow for the "most thorough analysis in the rulemaking itself." Clearly, the Direct Investment Regulation cannot stand on the record developed to date.

AFFIDAVIT

GEORGE G. KAUFMAN, being duly sworn, deposes and says as follows:

1. I am John F. Smith, Jr., Professor of Finance and Economics in the School of Business Administration of Loyola University of Chicago.

2. I have been involved in matters of banking and thrift regulation as an academic, practitioner and a re-seacher. I have been associated with the Federal Reserve Bank of Chicago and the Comptroller of the Currency, and was Deputy to the Assistant Secretary of Policy of the U. S. Treasury Department.

3. I am the author or co-author of numerous books and professional articles in the area of financial institutions and financial institution regulation. I am also on the boards of editors of several professional journals including the Journal of Money, Credit and Banking and the Journal of Financial and Quantitative Analysis.

4. I have been a member of the Board of Directors of the American Finance Association, past-President of the Western Finance Association and am currently President of the Midwest Finance Association.

5. I have served on task forces to investigate various aspects of financial institution safety and soundness sponsored by the Federal Home Loan Bank Board and the American Banker's Association and am currently working on major research projects in this area sponsored by the American Enterprise Institute and the Mid-America Institute.

6. I make this Affidavit to describe my analysis of the Federal Home Loan Bank Board's use of the results of a study performed by Messrs. Barth, Brumbaugh and Sauerhaft and entitled "Failure Costs of Government-Regulated Financial Failures: The Case of Thrift Institutions" (the OPER study) to support extension of its "Regulation on Direct Investigation by Insured Institutions", 12 C.F.R. §563.9-8. See 51 Fed. Reg. 32925.

7. From a sample of failed institutions, the OPER study statistically identifies determinants of the cost of failed insured SLAs to the FSLIC in the early 1980s. Six characteristics of the failed institutions are found to be significantly related to the losses experienced by FSLIC.

Direct investments is one of these, but is of relatively secondary importance. The most important variables are the delay between the time a failed institution became GAAP insolvent and when it was closed or declared insolvent by FSLIC and the cost of Federal Home Loan Bank advances to the failed institution. The last is related to the volume of advances to the institution. Both of these factors are directly under the control of the Federal Home Loan Bank Board and FSLIC. Thus, quicker action in resolving failures would be the most important and efficient cost-reducing strategy for the FHLBB. Indeed, the failure to close insolvent institutions faster may also contribute to the losses from the direct investments.

8. Most importantly, the OPER study does not deal with the factors that determine failure as opposed to the cost of failed institutions to the FSLIC. The same authors have addressed themselves to this problem in two other papers. The first paper, entitled "Thrift Institution

Failures: Causes and Policy Issues" by James R. Barth, R. Dan Brumbaugh, Jr., Daniel Sauerhaft, and George H. K. Wang, all of which at the time were associated with the Federal Home Loan Bank Board, was presented at a May 1985 conference sponsored by the Federal Reserve Bank of Chicago and subsequently published in the Proceedings volume. The second study, entitled "Thrift Institution Failures: Estimating the Regulatory's Closure Rule" was completed after the OPER study (a copy of this study is attached). Both studies examine a sample of failed and non-failed institutions to identify the causes of failure. Neither study finds that direct investments contribute to increasing the probability of institution failure. In the more recent study, the authors review the previous empirical studies that they consider to also be the most important. They find that direct investment is not a significant variable in explaining the probability of insured depository institution failure in any of these studies. They then proceed to construct another model explaining the probability of savings and loan association closures and test it for a sample of 340 closed and 628 non-closed thrift institutions over the period 1981 through 1984. Among the explanatory variables included in the model is the ratio of direct investments to total assets ("DITA"), measured both six months and one year before closure. On the basis of their tests, the authors conclude "the variable DITA is never significant, meaning that direct investments relative to total assets does not

affect the likelihood that an institution will be closed. This finding is consistent with earlier work by BBSW [the same authors] (1985a) and Benston (1985)... It is surprising that direct investments do not affect the likelihood of closure by the regulator who passed a regulation limiting direct investments" (pp. 14-16).

9. Because the earlier OPER study by the same authors finds that direct investments do increase the loss to FSLIC from failed and closed institutions, this suggests that the failed institutions increased their risky direct investments shortly before closure and that these losses could have been prevented by speedier action by the FHLBB in closing these institutions as soon as they became GAAP insolvent, no less market value net worth insolvent. Thus it appears that nothing in the OPER study or the other studies conducted by the same authors provides any justification for the FHLBB's regulation regarding direct investment nor do the authors of these studies make any such claim.

10. The same conclusions are reached by Professor George Benston of the University of Rochester in his revised 1985 study. In addition, Benston shows that the greater the proportion of direct investments to total assets for an institution, the lower is the risk of direct investments as

measured by the volatility of total returns and that, even though the greater is the total risk of the institution, the direct investment reduces the total risk below the risk of the remainder of the institution's portfolio. The risk reductions in both instances may be attributed to greater diversification. In sum, it appears that the Federal Home Loan Bank Board is using the OPER study for purposes of convenience to justify its own preconceived conclusions. In no way does either the OPER study or the other studies by the same authors provide justification for either the initial limitation on direct investment or the extension of this regulation beyond January 1, 1987. In addition, none of the studies examines the evidence for institutions whose direct investments exceed either 10 percent of their total assets or twice their net worth.

Further, Affiant sayeth not.

George G. Kaufman

Notary Public

My commission expires:

October 17, 1986

Director
Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Comments In Opposition to the
Proposed Extension by Amendment
of the "Regulation of Direct
Investment by Insured Institutions"
(51 Fed. Reg. 32925)

Dear Sir or Madam:

I am writing on behalf of Lincoln Savings and Loan Association in opposition to the proposed extension of the "Regulation of Direct Investment by Insured Institutions" (the "Rule" or the "Direct Investment Rule") (51 *Fed. Reg.* 32925) noticed by the Federal Home Loan Bank Board (the "Board"), and in response to the Board's request for comments thereon.

It is my professional opinion that the Rule should not be extended. I regard the rule as not only unwise but as potentially harmful to both the savings and loan industry and the Federal Savings and Loan Insurance Corporation ("FSLIC"). The Rule is unsupported by the sole study which the Board cites in its defense and is demonstrably in conflict with the relevant available statistical data.

I base my conclusions on the following facts:

1. Statistical research shows that direct investments do not increase risk to savings and loan associations or to the FSLIC fund.
2. Statistical research shows that direct investments tend to increase industry profitability and increase or are positively associated with higher net worth and, consequently, serve to prevent failures and protect the FSLIC fund.
3. The research paper on which the Board relies does not, and was not designed to, evaluate the effectiveness or the need for the Rule. It does not provide empirical support for the proposed extension of the Rule.
4. The Board's stated reliance on its "supervisory experience" to defend the Rule is analytically confused, inconsistent and unsupported. The Board relies on data that are irrelevant and ignores the experience of its own personnel that negates its claims in support of the Rule.
5. Even if one assumes for the sake of argument that direct investments increase "risk," the Rule has been rendered unnecessary by the Board's new Capital Requirements Rule.

On the basis of each of these reasons, which I discuss in greater detail below, it is my professional opinion that the Rule should not be extended.

1. The Data Indicate that Direct Investments Do Not Increase Risk to the Industry or to the FSLIC.

I have recently published what I believe is the most elaborate and comprehensive study made to date that examines the relationship between direct investments and risks to the savings and loan industry and to FSLIC. See George J. Benston, An Analysis of the Causes of Savings and Loan Association Failures, Salomon Brothers Center for the Study of Financial Institutions/Graduate School of Business Administration, New York University, Monograph Series in Finance and Economics, Monograph 1985-4/5 (1986).1/ In this monograph I studied all associations that failed between January 1, 1981 and August 31, 1985, analyzed in detail each of the individual associations that failed between these dates and that had five percent or more of its assets in direct investments, and examined all FSLIC-insured associations (a total of 2,377 associations) over the period from June 30, 1981 through June 30, 1984.

1/ I annex hereto a copy of this monograph.

The statistical data in this study show that:

(1) direct investments are "not significantly positively related to failure" (p. 72);

(2) statistically there is "no relationship between direct investments and [association] failures" (p. 119);

(3) "direct investments are not positively associated with FSLIC payments" (p. 72); and

(4) the "data do not support the FHLBB's assertion that direct investments are meaningfully associated with 'risky' assets and liabilities." (p. 118)

I concluded from these findings that:

> deregulation of investment powers was [not] a cause of the official failures. Consumer and commercial loans were negligible at the SLAs that failed. Direct investments -- defined as real estate held for development, investment and resale, and equity investments in service corporation subsidiaries -- were found to be neither a cause of failures nor responsible for higher FSLIC payouts at the associations that failed.

(p. 171)

2. Direct Investments Contribute Substantially to Industry Profitability and Help Prevent Association Failures

My study produced more than merely negative findings. It also revealed that direct investments tend to increase the profitability and net worth of associations and/or that associations with higher net worth tend to make

direct investments; consequently, the FSLIC fund is protected.

Specifically, the data show that:

(1) "there is reason to believe the direct investments have served to reduce the number of failures by increasing SLA [Savings and Loan Association] net worth and reducing their vulnerability to interest-rate risk" (pp. 122-123);

(2) "direct investments, more so than other assets, considerably increased net worth, or were made by associations that increased net worth for other reasons. In either case, the risk to the FSLIC is lower" (p. 115);

(3) the "average returns on direct investments for all of the size groups [of association] are considerably above the returns on other assets" (p. 94);

(4) "without direct investments, the average SLA would have had negative returns" (p. 94);

(5) "direct investments significantly improve the reported net returns to SLAs" (p. 95);

(6) "[t]hese higher returns reduce the risk that an SLA might fail, causing resources to flow from the FSLIC" (p. 121); and

(7) overall association "risk, as measured by the standard deviation of returns, is reduced by direct investments." (p. 99)

From these findings I concluded that:

> the data . . . indicate that direct investments provided SLAs with much higher earnings than did their other operations, while reducing somewhat the variance of earnings. More meaningful than the variance as a measure of risk to the FSLIC is the extent to which earnings are negative. The study found an inverse relationship between negative total net earnings and the proportion of assets in direct investments Hence, the regulation adopted by the FHLBB in 1985 that restricts direct investments to a maximum of ten percent of assets (unless the FSLIC-insured association obtains specific permission) appears to be counter-productive.

Id. at 171-72.

The policy implications of these findings seem clear. As I stated in my study:

> SLAs should be permitted to use their comparative advantage in real-estate-related projects to make and manage direct investments. The investments referred to are those that are the subject of the study presented in Chapter II -- assets that are owned by SLAs, not loans that the FHLBB defines as direct investments (generally low-borrowed-equity acquisition, development, and construction -- ADC -- loans). Direct investments offer SLAs several advantages over other investments. First, they tend to provide SLAs with higher earnings than can be obtained from many other investments and operations, apparently because they allow SLA managers to use their skills and experience in making and monitoring real-estate-related investments. Second, direct investments have shorter durations than many other assets in which SLAs have invested; hence, they reduce the institutions' exposure to interest rate risk. Third, the returns on direct investments tend to be imperfectly correlated with the returns from SLAs other activities; hence, the variance of returns tends to be reduced. All three factors reduce the risk imposed on the FSLIC.

Id. at 173.

This evidence shows that the Rule is not only unnecessary, but is also positively harmful to the industry and to the FSLIC.

3. The Statistical Research on Which the Board Relies Does Not Support the Rule

The Board cites a single research paper in support of the Rule.[2/] (51 Fed. Reg. at 32926) The paper does not, and cannot, provide support for the Rule.

The paper cited is directed towards evaluating different methods of measuring the capital structure of associations. It was not designed to examine the critical question that must be answered in attempting to evaluate the Rule empirically: do direct investments increase or decrease risks to associations and to the FSLIC fund? The paper did not attempt to examine whether direct investments make failure more or less likely, because the authors examined only those associations that had already failed. Consequently, the findings reported on the relationship between FSLIC payouts and direct investments are relevant, at most, only to the behavior, assets and liabilities of

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2/ James R. Barth, R. Dan Brumbaugh, Jr., and Daniel Sauerhaft, "Failure Costs of Government-Regulated Financial Firms: The Case of Thrift Institutions" (June, 1986).

associations that had close to zero or negative net worth. These associations face very different incentives than do those with sufficient net worth. Unlike most solvent institutions, the ones studied can benefit from taking great risks. Such risks might include, and certainly would not be limited to, direct investments that promise either very high returns or losses. But the proposed rule does not meaningfully apply to insolvent or near insolvent associations; they should be closed or closely monitored in all dimensions. Rather, the rule applies to solvent, sufficiently capitalized associations. The study cited does not provide any findings that pertain to this group.

Most important, the Board's paper does not (and was not designed to) take into account the substantial and undeniable benefits associations derive from direct investments.3/ It therefore ignores the extent to which increased profitability and net worth from direct investments have protected the FSLIC fund and enabled it to avoid the costs of additional failures that it would otherwise have had to bear. My monograph examined both the positive and negative results

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3/ The Board itself acknowledges that direct investments can be beneficial: "When properly underwritten, direct investments may be profitable for an institution and may sometimes offer more positive diversification benefits for the entire portfolio." 51 Fed. Reg. at 32926.

of direct investments, and consequently its findings are more comprehensive and balanced, and it bears directly on the merits of the Rule. Since direct investments were generally highly profitable and contributed to increased net worth, they most likely prevented many associations from failing. Collaterally, direct investments tended to be made by associations that held relatively higher levels of net worth. These findings are not contradicted by the Board's study. It does not show that direct investments are in general harmful or particularly "risky"; it does not question my findings about the general profitability of direct investments; and it does not contain any reason to doubt that profits from direct investments have helped prevent potential failures from occurring.

Moreover, although the Board's paper measured the relationship between asset holdings at failed associations and the size of FSLIC payouts, it was not directed at determining the variables related to failure. It makes no effort, for example, to measure the effect of past declines in asset values (such as those that arose from interest rate risk) on FSLIC payouts. The paper contains no variable measuring the losses associations incurred on mortgages and other long-term fixed interest obligations, and it contains no variable measuring the effect of such losses on the size of FSLIC payouts. Nor does it separate the effect of fraud (which has

a devastating effect on the FSLIC fund) from the effects of asset declines and liquidation losses.

However, another study conducted by the Board's Office of Policy and Economic Research did analyze the statistical relationship between direct investment and the probability of failure. This study4/ found, as did the research I conducted that is discussed above, no significant relationship. It thus indicates that direct investments do not cause associations to fail.

Importantly, it should be noted that an association "fails" when the FSLIC chooses to close it or have it merge with another institution. As the paper cited by the Board states, "the decision about when an institution has failed is a regulatory one. As a result, not all insolvent thrift institutions are failed." (p. 4) Considering the Board's belief that direct investments are especially risky, one would expect that the Board has monitored associations that hold relatively high amounts of direct investments more closely than it has monitored other associations and that the Board has closed or merged ("failed") those that become

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4/ James R. Barth, Jr., R. Dan Brumbaugh, Jr., Daniel Sauerhaft, and George W.K. Wang, "Thrift Institution Failures: Causes and Policy Issues." Proceedings of a Conference on Banking Structure and Competition, Federal Reserve Bank of Chicago, 1985, pp. 184-216.

insolvent. Hence, studies that examine failed associations and seek to explain their failures would likely be biased towards finding a significant, though spurious, positive relationship between direct investments and "failures." The fact that neither the Board's study nor mine found any such significant relationship indicates, if anything, that direct investments are inversely related to economic (as contrasted to regulatory) failure.

4. The Board's Reliance on Its "Supervisory Experience" Is Confused, Inconsistent, and Unsupported

The Board states that it relies on its "supervisory experience" to support the Rule. I find its position here to be confused, inconsistent and unsupported.

As its notice of proposed extension indicates, the Board's position is based on a refusal to distinguish carefully between certain types of loans (particularly certain acquisition, development and land ("ADL") loans) and direct investments.5/ Regardless of the extent to which ADL loans

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5/ The Board has, by rule, determined that certain types of "loans" should be treated as "direct investments." See 50 Fed. Reg. 18233 (April 29, 1985). The problem with this rule, as with the Board's direct investment regulation, is that it refuses to recognize the differences between ADL and other types of loans that create special risks and straight-forward direct (Continued)

and direct investments may, in some ways, be considered as similar, they are quite different in important respects. If the Board has evidence that increased risks arise from ADL loans, such evidence may constitute a reasonable basis to regulate these loans. But this evidence is not a reasonable basis on which to regulate true direct investments. Indeed, the single research paper on which the Board relies shows that ADL loans are as related to higher FSLIC payouts as are direct investments at failed associations. Nevertheless, the Board persists in limiting direct investments while ignoring the apparently equally troubling ADL loans. The Board should either take its paper seriously or, better yet, ignore it completely. To regulate only direct investments on the basis of the paper cited is confused and inconsistent.

Further, the Board's contentions in support of the Rule are inconsistent with at least much of its actual supervisory experience. A very considerable part of the Board's supervisory experience, in fact, yields conclusions

(Continued)
investments (where the association owns and directly manages the property), that it refuses to focus its regulations on the types of loans it sees as possibly troublesome, and that it insists on attributing to true direct investments the dangers which it sees in these troublesome loans. As a result, its economic analysis is confused and it has undertaken dysfunctional regulatory actions.

flatly contrary to those the Board states in attempting to support the Rule. Mr. Scott Taylor, a Board employee who was in charge of liquidating failed associations, recently summarized the results of his supervisory experience, as follows:

> For more than two years I have been in charge of liquidating failed FSLIC-insured institutions. During that time over 50 institutions were placed in receivership, and 26 were so badly scarred that they are being fully liquidated, with over $3.2 billion in historical assets.
>
> Those companies did not fail because of misuse of broader asset and investment powers, or because of direct investments in real estate. They failed because of fraud, incompetence and criminality which was not deterred or detected early enough, and which has little if anything to do with the ability to make direct equity investments or with broader asset powers.
>
> Despite strong assertions by some, I can see no basis to claim that direct investment authority is a cause of increased failure or a risk to the FSLIC. But if regulators do not examine and supervise adequately to prevent and deter wrongdoing, crime, fraud and incompetence *will* cause increased failures regardless of legal limits on investments. It is difficult to see the wisdom of barring the great majority of sound, well-managed savings institutions from safe and profitable business simply because regulators fail to prevent or deter others from crime.[6/]

6/ I am attaching hereto a copy of the complete letter, dated November 29, 1985, from Mr. Taylor to Mr. George P. Rutland.

For these reasons, the Board's reliance on its supervisory experience to defand the Rule is inconsistent and unsupported by evidence.

5. The Board's Rule Increasing Capital Requirements for Associations Has Made the Direct Investment Rule Unnecessary

The Board has asked specifically whether there is any continued need for the Rule in the wake of its new capital requirements regulation (the "Capital Requirement Rule"). See 51 Fed. Reg. 33565 (September 22, 1986). The short answer is that there is no such need.

I agree with the general approach taken in the Capital Requirement Rule, to raise the general level of net worth that associations must maintain. Such higher net worth will serve as an additional and strong inducement to associations to operate soundly and prudently, and it will provide a larger cushion to forestall the FSLIC fund from having to absorb losses.

The Capital Requirement Rule makes the Direct Investment Rule unnecessary. The Board has defended the Direct Investment Rule on the ground that it will prevent associations from engaging in risky investment practices and will reduce losses to the FSLIC. Even if the Rule contributed to these goals -- a conclusion which is unsupported and inconsistent with the evidence -- the Capital Requirements

Rule will achieve the goals more efficiently and effectively. The reasons for this are simple.

First, the Capital Requirements Rule will induce greater caution and help insure sound investment practices, while at the same time it will preserve the operational flexibility and market freedom which is restrained by the Direct Investment Rule. It will discourage risky investments while still allowing associations to undertake promising opportunities for profitable direct investments.

Second, the Capital Requirement Rule will create an added safety cushion to protect associations and the FSLIC against losses. The Direct Investment Rule, however, will likely hinder associations (particularly mutuals) in their efforts to meet the required higher net worth levels. Since direct investments increase industry profitability and net worth, associations can use direct investments to help them meet and maintain the higher capital requirements. The Direct Investment Rule would then be an obstacle to associations attempting to reach the higher and more desirable protection levels set by the Capital Requirements Rule.

Third, the Board's Capital Requirements Rule makes an additional capital requirement for direct investments unnecessary. Higher required levels of capital work to reduce incentives for associations to engage in all types of excessive risk taking. Low and negative levels of capital

encourage excessive risk taking of many types, of which direct investments is only one possible alternative. Indeed, it is easier for risk-prone associations to attempt to gain large profits at the risk of having to take large losses by such means as purchasing long-term fixed-interest obligations, buying or selling interest-rate futures and options, and making risky loans with large up-front fees. Only a general, rather than a specific, capital requirement can address effectively the problem of excessive risk taking.

6. Conclusion

For these reasons, I conclude that there is no reasonable economic need for the Direct Investment Rule, that the Board's statistical research and "supervisory experience" do not support the Rule, and that the Rule should not be extended.

Further, I request that the Board extend the comment period for sixty days to allow the public to comment more fully and fairly upon the Rule. I am currently working on an update of my earlier research, and the brevity of the comment period has prevented me from completing it within the Board's announced time limits. I think my updated research

will have considerable value for the Board and the public in evaluating the Rule.

Yours truly,

George J. Benston

George J. Benston

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October 17, 1986

Hand Delivered

Director
Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Re: Proposed Rule to Extend the Expiration Date of the Federal Home Loan Bank Board's Direct Investment Regulations

Dear Sir:

We represent a number of savings and loan associations the accounts of which are insured by the Federal Savings and Loan Insurance Corporation ("FSLIC"). This letter is submitted in response to the proposal of the Federal Home Loan Bank Board ("FHLBB") to extend the expiration date of the FHLBB's direct investment regulation, found at 12 C.F.R. § 563.9-8 ("Direct Investment Regulation"), to January 1, 1989. See, 51 Fed. Reg. 32925 (September 17, 1986). The Direct Investment Regulation, which generally restricts the type and amount of permissible direct investments b[y] FSLIC insured institutions ("insured institutions"), became effective on January 31, 1985 and by its te[rms] set to expire on January 1, 1987.

As discussed in greater detail below, the Direct Investment Regulation should not be extended for the following reasons:

-- The Direct Investment Regulation improperly restricts the authority of the states to regulate the investment decisions of state-chartered insured institutions.

-- The FHLBB lacks the statutory authority to promulgate and extend the expiration date of the Direct Investment Regulation.

-- The promulgation of the Direct Investment Regulation is in contravention of the express provisions of the Administrative Procedure Act.

Consequently, the FHLBB should reconsider the proposed extension of the expiration date of the Direct Investment Regulation and defer to the discretion of the state regulators with respect to the permissibility of the investment decisions of state-chartered insured institutions. In the alternative, the comment period should be extended so that the FHLBB and the thrift industry can thoroughly analyze the impact of the Direct Investment Regulation, particularly in light of the promulgation of the FHLBB's new capital requirements, to be found at 12 C.F.R. § 563.13. _See_ 51 Fed. Reg. 33565 (September 22, 1986).

I. **THE DIRECT INVESTMENT REGULATION IMPROPERLY RESTRICTS THE AUTHORITY OF THE STATES TO REGULATE THE INVESTMENT DECISIONS OF STATE-CHARTERED INSURED INSTITUTIONS**

The extension of the expiration date of the Direct Investment Regulation represents a continuation of the FHLBB's improper assertion of power over the investment activities in which state-chartered insured institutions permissibly may engage. The FHLBB's proposed action would continue to thwart the efforts of the individual states to enable state-chartered insured institutions to meet the credit needs of the people and institutions in those states and represents a continued assault on the dual federal-state chartering system.

In addition, the adoption and extension of the Direct Investment Regulation is in direct contravention of the express intent of Congress to defer to the states in determining the appropriateness of the investment activities of state-chartered insured institutions. See, e.g., West Helena Savings and Loan Ass'n v. Federal Home Loan Bank Board, 553 F.2d 1175, 180 (8th Cir. 1977) (Congressional statutes "created and contemplate the continued existence of a dual system of savings and loan associations. . . .") This Congressional intent is reflected in several major pieces of banking legislation

recently enacted by Congress. See, e.g., Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132-93 (1980); Garn-St Germain Depository Institution Act of 1982, Pub. L. No. 97-320, 96 Stat. 1492 (1982). In both of these acts, Congress refused to tighten federal control over state-chartered insured institutions, particularly in the face of broader investment powers conferred upon such institutions by the states. To the contrary, these laws loosened restrictions on insured institutions by eliminating geographical lending restrictions and conferring broad new asset powers on federally chartered savings and loan associations. In fact, the Garn-St Germain Act, which established a special federal assistance program for troubled, insured institutions, imposed investment limitations only on troubled institutions which required special federal aid. Congress clearly intended to leave to the states the control of the investment powers and practices of state-chartered insured institutions.

II. THE BOARD LACKS STATUTORY AUTHORITY TO PROMULGATE OR EXTEND THIS RULE

The statutes originally relied upon by the FHLBB in promulgating the original Direct Investment

Regulation did not provide the FHLBB with authority to prohibit conduct of state-chartered insured institutions which otherwise has been authorized by state law. Nothing on the face of these statutes or in their legislative histories supports the FHLBB's assertion of power to intrude into areas which Congress has historically and quite purposefully kept within the authority of the states.

For example, Section 407 of the National Housing Act ("NHA"), 12 U.S.C. § 1730, does not authorize across-the-board regulation of practices deemed unsafe and unsound by the FHLBB. Rather, that section merely permits case-by-case adjudications by the FHLBB of unsafe or unsound practices. Section 402 of the NHA, 12 U.S.C. § 1725, is equally unavailing as a source of authority for this type of regulation. While Section 1725 grants some rulemaking authority, it does not grant the FHLBB blanket authority to bypass the method expressly ordained by Congress to deal with unsafe and unsound practices -- individual case-by-case adjudications mandated by § 1730.

III. THE PROMULGATION OF THE DIRECT INVESTMENT REGULATION IS IN CONTRAVENTION OF THE EXPRESS PROVISIONS OF THE ADMINISTRATIVE PROCEDURE ACT

The Administrative Procedure Act, 5 U.S.C. § 551 *et seq.*, mandates that an administrative agency reference the source of legal authority for its action prior to promulgation of a rule. 5 U.S.C. § 553. As previously discussed herein, the FHLBB's proposal merely cites provisions of the FHLBB's jurisdictional statutes without providing any type of analysis in support of its legal authority to promulgate the Direct Investment Regulation. This omission is especially troubling in light of the comments initially received by the FHLBB when the Direct Investment Regulation was first proposed, disputing the validity of the FHLBB's legal authority to adopt it such regulation.

Further, it is well established that an agency has a duty to consider responsible alternatives to its chosen policy and to give a reasoned explanation for its rejection of such alternatives. *See, e.g., Farmers Union Central Exchange, Inc.* v. *FERC*, 734 F.2d 1486, 1511 (D.C. Cir.), *cert. denied*, 105 S.Ct. 507 (1984). However, it appears that the FHLBB has failed to consider regulatory alternatives to the Direct Investment Regulation. In fact, the commentary

accompanying the proposed rule suggests that the FHLBB has recognized that the extension of the Direct Investment Regulation in its present form may no longer be necessary in light of the FHLBB's recent adoption of higher regulatory capital requirements for insured institutions. See 51 Fed. Reg. 33565 (September 22, 1986).

Finally, in proposing this amendment, the FHLBB has failed to provide an appropriate comment period, consistent with its own policy expressed in FHLBB's "Rulemaking and Regulatory Simplification Notice," Board Res. No. -80-584, 45 Fed. Reg. 63135 (September 23, 1980), which provides for at least a sixty-day comment period unless the FHLBB states in its published notice the reasons why a shorter period is practical or necessary. The FHLBB merely has relied on its own assertion that a shorter comment period is appropriate because "the direct investment rule has been previously published for public comment and because the public interest requires prompt Board action." 51 Fed. Reg. 32927 (September 17, 1986).

The FHLBB's rationale does not provide a sufficient basis to justify a shortened comment period. First, the FHLBB has acknowledged that new capital

requirements, which will become effective subsequent to the original promulgation of the Direct Investment Regulation, may substantially affect the need for the extension of the Direct Investment Regulation. Second, the FHLBB also has recognized the need to assess "after sufficient experience with the rules, whether the approach taken had been effective in controlling risk and whether further regulatory action was required. . . Since the FHLBB has not had the opportunity to analyze the continued need for the Direct Investment Regulation in light of the new capital requirements, the FHLBB should extend the comment period in order to make meaningful comment and analysis possible.

CONCLUSION

In light of the foregoing, the FHLBB should not extend the expiration date of the Direct Investment Regulation. In the alternative, the comment period should be extended so that the FHLBB's proposal can be analyzed by the FHLBB and the savings and loan industry in light of the new capital requirements.

Sincerely,

Richard M. Alexander

AMERICAN SAVINGS
AND LOAN ASSOCIATION OF FLORIDA

EDWARD P. MAHONEY
PRESIDENT AND
CHIEF OPERATING OFFICER

October 17, 1986

Director
Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Re: Extension of Direct Investment Rule

Dear Sir:

American Savings and Loan Association of Florida opposes extension of 12 C.F.R. 563.9-8, Regulation of direct investment in equity securities, real estate, service corporations, and operating subsidiaries.

American Savings is of the opinion that extension of the Direct Investment Rule is unnecessary due to the adoption of the Final Rule on Regulatory Capital. As the FHLBB stated in its supplementary information on the final rule on regulatory capital under Direct Investments:

> . . . (T)he Board has also determined, after consideration of the comments and a further review of its empirical studies and supervisory experiences . . ., that direct investments made by a well managed and well capitalized institution may not require the same specific safeguards. The possible institutional failures and costs to the FSLIC associated with direct investments are greatest when such investments constitute a large percentage of the investments of an institution with low capital.

The Final Rule on Regulatory Capital effectively limits direct investments because of its additional capital requirements on such investments exceeding certain thresholds based upon an institutions' regulatory capital levels. Although certain direct investments are grandfathered, those direct investments were either grandfather by the Direct Investment Regulation or made between December 10, 1984 and June 30, 1986 pursuant to the Direct Investment Regulation.

As a Florida-chartered, FSLIC-insured thrift, American Savings has substantial direct investment authority under state law. Florida law would allow American Savings to invest up to 20 percent of its assets in

Federal Home Loan Bank Board
Extension of Direct Investment Rule
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Page Two

"direct investments" and the lesser of its net worth or 10 percent of assets in direct real estate investments. However, the Final Rule on Regulatory Capital limits such investments. At September 30, 1986, American Savings had regulatory net worth slightly in excess of 7 percent, or $170 million of regulatory capital, including approximately $13.5 million of appraised equity capital. Pursuant to the Final Rule on Regulatory Capital, American Savings could have direct investments equal to 10 percent of assets (approximately $250 million) without incurring additional capital requirements. American Savings actual direct investments total approximately $125 million.

American Savings would agree to support a continued prohibition in investment in savings and loan stock below the amount required to be deemed a savings and loan holding company, but does not agree that additional restrictions on direct investments, given the adoption of the Final Rule on Regulatory Capital, are appropriate.

Sincerely,

Edward P. Mahoney

Edward P. Mahoney

EPM/mjo

cc: Honorable Edwin J. Gray
Honorable Donald I. Hovde
U. S. League of Savings Institutions
Florida League of Financial Institutions

JONES, DAY, REAVIS & POGUE

AUSTIN
CLEVELAND
COLUMBUS
DALLAS
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October 17, 1986

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INFORMATION SERVICES
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Director, Public Information
Services Branch
Office of the Secretariat
Federal Home Loan Bank Board
1700 "G" Street, N.W.
Washington, D.C. 20552

Re: Board Resolution No. 86-962 Regulation of Direct Investment by Insured Institutions

Dear Sir or Madam:

This firm appreciates the opportunity to comment on behalf of several clients on the Board's proposal to defer the expiration of its regulation governing investments by insured institutions in "direct investments" (i.e. - equity securities, real estate, service corporation and operating subsidiaries) published at 51 Fed. Reg. 32925 (September 17, 1986). We strongly encourage the Board not to extend this form of direct investment regulation. We do not believe that the Board has demonstrated that the regulation has a substantial effect on improving the safety and soundness of insured institutions or decreasing the risk to the FSLIC fund. Further, even if one were to accept the premise that direct investments inherently involve more risk than other investments permitted to insured institutions, the current regulation is ineffective. It requires subjective standards to be applied in a time consuming manner. The application process has caused uncertainty due to the lack of a consistent basis for approval or any reasonable time frames for review of the application. Accordingly, we believe that the Board has other, more effective devices to regulate this area.

Current Regulation Ineffective

A primary basis employed by the Board to justify extension of the cumbersome direct investment rule is an empirical study conducted by the Board's own staff: "Failure Costs of

Government-Regulated Financial Firms: The Case of the Thrift Institution" (the "Study"). The Study identifies six characteristics of failed nst tutions that are significantly related to losses experienced by the FSLIC. While direct investment is one characterist c it was determined to be of secondary importance. Nevertheless the Board concluded from the Study that direct investments by failed institut ons may increase the FSLIC's cost The Study does not state that an institution that makes d rect nvestments is more likely to fail, thus it is unclear what relevance the Study has to the Board's stated purpose of reducing the exposure of insured institutions and the FSLIC insurance fund to risk.

There is a simple explanation to the fact that direct investments of failed thrifts are more costly to the FSLIC. An institution that is nearly insolvent on a RAP basis is generally insolvent on a GAAP basis. Accordingly, management and owners of such institutions are aware that they have no recognizable value in the nst tution. At this point they would be inclined to make extremely high-risk direct investments (as well as other investments permitted to insured institutions) that would result in either a profit that will provide the institution with solvency on a GAAP basis or provide the FSLIC, as receiver, with the significantly increased costs determined in the Study. Indeed, the inability of FSLIC to take control of a GAAP- nsolvent institution was pointed to as a major cause of ncreased costs to the FSLIC in a recent article written by the same Board staff members who performed the Study.1/ Accordingly, we do not believe that the Study or other information provided by the Board requires the conclus on that direct investments are not riskier in the absolute but may be subject to increased risks in situations where an institution has little to lose and much to gain.

Further, the Study does not distinguish between failed institutions that have direct investments in excess of the threshold of 10 percent of assets or twice regulating net worth and institutions that have made direct investments not requiring prior Board approva Accordingly even assuming that there is a determent to the FSLIC from direct investments, the Board had not demonstrated that the prior approval requirement currently under review is effective in solving the perceived problem.

1/ See, James R. Barth, Donald J. Bisenius, R. Dan Braumbaugh, Jr. and David Sauerhoft, The Thrift Industry's Rough Road Ahead, Challenge 38 (September/October 1986).

<u>Alternative Regulation</u>

The Board has requested comment on more flexible solutions to problems with direct investments. The requirement that prior regulatory approval be sought for certain types of investments as well as all direct investments over a threshold level is extremely inflexible and burdensome on the institution and the Board's staff. The experience of our clients indicates that the time required for review of applications is unpredictable, yet, the evidence provided by the Board in its discussion of the proposal to extend the rule suggests that the Board and its delegates have not substantially limited direct investments. The Board has stated that in slightly less than nine of 10 applications the investment is approved. Through the prior approval requirement, the Board has hindered the ability of an institution's management to make timely decisions concerning investments. This regulatory lagtime may cause an institution to miss an opportunity to make an investment at a time such investment would be more profitable. Accordingly, we believe that the Board should not extend a rule requiring review when approval is almost always granted, and that such time consuming, pro forma approvals are a basis for rescinding the regulation, <u>not</u> extending it.

There are several actions the Board could take to lessen the risk to the FSLIC from direct investments. A primary concern of the Board should be imprudent direct investments made by desperate management of GAAP-insolvent institutions. First, the Board should make more efficient use of its staff. By alleviating the burden of reviewing applications for approval of direct investments by healthy, well-run institutions, the staff would be able to regulate more closely the investments of financially-troubled institutions. The Board could limit the approval requirements to review of direct investments by institutions with minimal capital as it has done in the branch sale context. <u>See</u> 12 C.F.R § 571.5(j)(3) (1986). Such an express procedure is probably unnecessary, however, in light of the far-reaching supervisory powers the Board possesses over institutions failing to meet their regulatory capital requirements. <u>See</u> 12 C.F.R. § 563.13(d) (1986). Further, by freeing the staff from the meaningless review of proposed direct investments by well-managed institutions, the Board could act to close insolvent institutions more quickly, effectively depriving desperate management from making ill-advised investments. Finally, the Board should continue the steps it has taken to require the industry to report to the Board on a GAAP basis. If the Board is authorized to close an institution as soon as it becomes insolvent on a GAAP basis, management will be less inclined to make ill-advised investments.

While we do not believe that a general correlation has been demonstrated between direct investments and increased risk of failure of an institution, the most direct fashion of dealing with this issue is through increased capital requirements. In its discussion of the subject proposal, the Board made note of its efforts to regulate direct investment through its newly-revised regulatory capital requirement rules. Under the regulations adopted on August 15, 1986, an institution's contingency factor of its regulatory capital requirement will be increased based on the amount of direct investments made by the institution. Further, the amount of the increase will depend on the current amount of capital of the institution, such that institutions with less capital must obtain greater amounts of additional capital for each direct investment. This system will allow an institution to make prudent direct investments based on market factors rather than regulatory approvals, and will protect against poorly capitalized institutions making high-risk direct investments. In light of these stringent capital requirements, the prior approval of direct investments by the Board is now superfluous. Accordingly, we strongly urge the Board to allow the prior approval requirement of its regulation of direct investment by healthy institutions expire, continue to monitor the need for increased capital requirements based on direct investments, and concentrate on direct investments made by institutions that are insolvent on a GAAP basis.

Thank you for consideration of these matters.

Very truly yours,

C. Thomas Long

C. Thomas Long

cc: Joseph Longino, Esq.

ECONOMIC CONSULTANTS
A. Gary Shilling & Company, Inc.
111 BROADWAY NEW YORK NY 10006

COMMENT ON THE FEDERAL HOME LOAN BANK BOARD'S PROPOSAL TO EXTEND THE EXISTING PREAPPROVAL REQUIREMENTS ON DIRECT INVESTMENTS

A. Gary Shilling & Co., Inc.

October 17, 1986

Member New York Stock Exchange

Comment on Extention of Direct Investment Regulation

We believe the FHLBB's supervisory review process for direct investments should not be extended past December 30, 1986. The intent of the rule is fulfilled by new regulations on net worth and balance sheet reporting, as well as the FHLBB's enhanced power for supervisory control through implementation of the classification rule. Continuation of the current rule would impose unneccessary costs and delays on thrifts contemplating direct investments, without enhancing the effectiveness of the new regulations.

As the proposal for continuing the direct investment supervisory rule notes:

> "The direct investment regulation was designed to allow institutions the flexibility to exercise their investment powers, as independently authorized by applicable law, in a manner that would expose neither the institution nor the FSLIC to an unacceptable level of risk, while at the same time ensuring that these institutions continue to fulfill their obligation to provide economical home financing."

The guarantee that a firm is operating in a safe and sound method is insured by the new net worth requirment, which requires additional capital for <u>all</u> direct investments by thrifts with less than 6% RAP capital and on direct investments in excess of 10% of total portfolio for thrifts with more than 6% RAP capital. The guarantee that they are still fulfilling their obligations for economical home finance is ensured by the 60% thriftness test.

Violations of either the additional net worth requirement or the thriftness test are now easier for the FHLBB to spot due to the new monthly reporting cycle. Moreover, spot checks of thrifts near the additional capital thresholds are possible under the FHLBBs normal auditing procedures — with the power of the classification rule available to bring miscreant thrifts back within "safe and sound" guidelines.

We agree that in recent years direct investments have increased the cost of failures to the FSLIC, as supported by the FHLBB's recent papers on this topic. We point out, however, that these papers were based on data collected during a time period in which thrifts could — while still satisfing the letter of the law — invest heavily in direct investments with little or no new capital. That investments made in this "head I win, tails FSLIC loses" world went bad should not be surprising.

As we noted in our earlier comment letter on the proposed net worth regulation, the basic problem of the early 1980s was not direct investment, but uncapitalized direct investment. Furthermore, the problem was caused not simply by direct investment, but the rate of growth in these investments and other risky asset types — usually by institutions with inadequate capital bases. The majority of liquidations in the 1983-85 period involved cases of hypergrowth, and majority of thrifts currently operating under supervisory administration are also hypergrowth cases.

The problem of hypergrowth was more than adequately dealt with last year in the new growth regulations. Indeed, the recent revision to exempt thrifts with more than 6% capital from the preapproval requirement is a definite improvement. Similarly, the problem of undercapitalization is very effectively dealt with in the FHLBB's recently finalized net worth regulation. With respect to direct investments the steep additional capital requirements, combined with the need to meet capital requirements on a contemporaneous basis, place the investing thrift at significant risk in any direct investment. Given this existing disincentive to direct investments, we feel second guessing a thrift's management through the preapproval process is unneccesary.

Indeed, the strongest argument against the extention of the need for pre-approval for increasing direct investment above certain threshholds is the current track record of the review boards. Of the 140 applications put before the boards since the rules inception 42 are still pending. The time delays involved in recieving pre-approval, and the filing process itself, are not costless to the filing thrifts. Particularly disconcerting is the fact that that 23 applications were dropped before a final solution was handed down. Clearly either the investment opportunity became unattractive due to the delay or the filing thrifts realized the weak merits of their application. The new additional capital regulations provide a significant enough deterent to spurious investments, while the potential loss of viable investment opportunities and cost of filing are unreasonable burdens for well run thrifts to suffer.

Finally, the fact that only 14 of the 98 applications acted on have been rejected is a strong argument against, not for, the retention of this pre-approval process. The cost of filing and the potential loss of investment oppurtunities for the 86% of thrifts not rejected must be weighed against the potential savings to the FSLIC from the rejections. The FHLBB must ask itself whether these 14 rejected investments would actually have been made if the applying institution had to put up at least 11% in basic capital — on a contemporaneous basis. (Current regulations require 6% on the underlying liabilities of a for a well capitalized thrift plus 5% for for supassing the 10% direct investment threshhold. A more weakly capitalized thrift would have to put up at least 3% on the underlying liabilities and 10% in additional capital for direct investment in excess of 10%).

The board points out that at least 5 of the 14 rejected applications came from one institution. We assume they were rejected because the firm was already in a deficit capital position, or heavily invested in direct investments. Could such a firm meet the 13%-plus capital requirement for weak thrifts desiring to make direct investments over 10% of the asset portfolio (16% if the direct investment was funded by new deposits). More importantly, would the PSA board have rejected any proposal where the thrift had the appropriate amount of capital?

In conclusion, we feel the existing regulation for preapproval of direct investment in excess of 10% of a thrifts portfolio is unnecessary. The triumpharate of the FHLBB's new monthly reporting system, combined with the need for thrifts to meet capital requirements quarterly (on a contemporaneous basis) and the FHLBB's power to employ supervisory overview on capital deficit thrifts provide a powerful deterent to undercapitalized direct investment. The steep levels of capital required on direct investments in excess of 10% of a thrifts portfolio provide substantial protection to the FSLIC and to the investing institutions ability to continue operating -- and fulfilling its obligation to provide for adequate home finance -- even if the investment turns sour. Both of the regulations original purposes are still enforced. This redundant regulation, which adds costs to the system with improving safety to the FSLIC, should be dropped.

Silverado Banking

Michael R. Wise
Chairman Of The Board
Chief Executive Officer

October 21, 1986

Mr. Herbert L. Mayberry, Director
Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Sir:

We appreciate the opportunity to comment on the Bank Board's proposal of September 17, 1986, to extend the existing direct investment regulation scheduled to expire January 1, 1987.

The Board is seeking public comment on whether the sunset date of the existing regulation should be extended to January 1, 1989. The Board is further inviting comment upon the administrative flexibility of the direct investment regulation, particularly in light of the agency's recent adoption of higher regulatory capital requirements.

Because of the Board's increased capital requirements for FSLIC institutions scheduled for January, 1987, and beyond, we believe that the direct investment threshold can safely be raised to 15% for those institutions meeting the new capital requirements. We have found that direct investments, when utilized properly and prudently, have proven to be a valuable management tool. Concurrently, we would recommend that the Board form a task force in cooperation with the industry's trade associations to study the effects of direct investments in helping institutions restructure their balance sheets. We believe that a comprehensive study on the part of a blue ribbon task force would serve to eliminate the many misconceptions that abound regarding direct investments, therefore, shedding additional light on this important investment vehicle.

Silverado Banking is a FSLIC insured savings institution with $1.6 billion in assets, and $72 million in regulatory capital. It operates 14 retail offices in the metropolitan areas of Denver and Colorado Springs and the mountain resort community of Frisco. Principal officers include Michael R. Wise, Chairman of the Board and Chief Executive Officer; Richard K. Vandapool, Vice Chairman and Chief Operating Officer; Robert M. Lewis, Vice Chairman and Chief Financial Officer; and, John C. Lohmeyer, Senior Vice President and Director of Corporate and Public Affairs.

Silverado Banking • Colorado Blvd. at I-25 • 3900 E. Mexico Avenue • Denver, Colorado 80210 • (303) 759-5225

Mr. Herbert L. Mayberry, Director
Page 2
October 21, 1986

In view of this recommended study, we encourage the Board to initiate a single year extension of the rule, rather than a two year extension as it is currently proposed. This will allow adequate study time and proposed revisions to the rule, if that is warranted based on the findings of the task force.

Should you wish additional input or clarification on this important rule, please do not hesitate to contact John Lohmeyer or myself.

Sincerely,

Michael R. Wise

Michael R. Wise

JCL:ckb

National Association of
State Savings & Loan Supervisors

Voice of the State Chartered System

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October 24, 1986

Honorable Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

RE: Regulation of Direct Investment by Insured Institutions—Federal Register No. 86-962

Dear Chairman Gray:

On September 17, 1986, the Federal Home Loan Bank Board published for public comment a proposed rule which would amend its existing regulation governing investments by institutions the accounts of which are insured by the Federal Savings and Loan Insurance Corporation in equity securities, real estate, service corporations, and operating subsidiaries. This proposed amendment to the "direct investment" rule would defer the expiration of the rule from January 1, 1987 to January 1, 1989. The FHLBB has indicated that it is specifically requesting comment on the administrative flexibility of the "direct investment" rule and, moreover, the continued need for the rule in its present form in light of the FHLBB's recent adoption of higher regulatory capital requirements for insured institutions.

The National Association of State Savings & Loan Supervisors appreciates the opportunity to comment on this proposal. The "direct investment" rule should be given the careful consideration of all concerned parties. NASS&LS views this proposal as of the utmost importance. Specifically, NASS&LS believes that the issue of whether the "direct investment" rule is still necessary in light of the FHLBB's recently promulgated regulation pertaining to the capital requirements of insured institutions deserves the highest level of scrutiny. There is not universal agreement as to the appropriateness of the existing regulation, much less the issue of extending the "sunset" provision for an additional two years. Many believe that the existing regulation was illconceived and hastily put into effect. Others believe that the regulation is essential. As the representative body of the state regulatory arm of our dual system of regulation in the financial institutions area, NASS&LS believes that this regulation, which directly impacts NASS&LS' members and, moreover, the institutions of which they are the primary regulatory authorities, and in light of the data available, does not need to

be, and therefore should not be, extended beyond the originally contemplated expiration date of January 1, 1987.

To our knowledge and belief, no significant empirical data has been produced by either the FSLIC or any other person or entity which warrants an extension of the regulation for an additional two years. The FHLBB has had a sufficient period of time within which to analyze and evaluate the success or failure of the regulation and, moreover, the underlying rationale and basis upon which it was initially promulgated. The proposal does not speak to any empirical data other than a survey which studies the extent to which direct investments in the portfolios of failed institutions increase the cost to the FSLIC. This survey does not address the success or failure of the investment policies of operating institutions, the causes of the failure of the institutions studied, the level of direct investments in various institutions or a variety of other relevant factors which at a minimum must be considered. In the absence of any additional studies of a more extensive nature, the FHLBB does not appear to have the data which would clearly indicate a need for the regulation. As the Honorable Doug Barnard, Jr., Chairman of the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations stated in his comment letter dated October 2, 1986, "In the absence of a comprehensive study by the [FHLBB], the rule should be renewed, if at all, only after the most thorough analysis [of] the rule making itself." NASS&LS concurs with this position.

In light of the FHLBB's new regulation relative to regulatory capital requirements, which expressly addresses direct investments by insured institutions, NASS&LS must conclude that this proposal to extend the "sunset" provision for an additional two years is unnecessary. The recently adopted regulatory capital requirements specifically call for increased reserves relative to direct investments by insured institutions. This element of the FSLIC's regulatory scheme would appear to respond to the FSLIC's acknowledged concerns in a more appropriate manner. Well capitalized institutions are provided a higher degree of freedom to conduct their operations. The perceived problems which prompted the promulgation of the "direct investment" rule would seem to be addressed by the new regulatory capital regulation.

As an alternative to the present proposal in which the existing regulation is either extended or permitted to "sunset", NASS&LS proposes a review of the substantive aspects of the regulation. After an extensive comment period, possible substantive revisions and modifications might be in order.

NASS&LS again stresses the favorable impact our dual system of supervision and regulation has had on the system of financial institutions in this country. The dual system of supervision and regulation has fostered new and innovative products and services over the many years. The "direct investment" rule is one regulation which borders on transgressing the time honored and time tested boundaries of our dual system.

NASS&LS would like to reiterate its support for the FHLBB and its overriding concern for the safety and soundness of the thrift industry and specifically the FSLIC. NASS&LS is second to none in its vigil to see that participants in the thrift industry conduct themselves in a safe and sound manner. However, we again stress our belief that quality supervision rather

than excessive regulation will achieve this goal more quickly. NASS&LS once again extends to the FHLBB its offer of support and assistance in whatever way possible to achieve our common goal.

NASS&LS respectfully requests that the foregoing comments be committed to the record on this matter and expresses its appreciation for your consideration thereof.

Very truly yours,.

THE EXECUTIVE COMMITTEE OF THE
NATIONAL ASSOCIATION OF
STATE SAVINGS & LOAN
SUPERVISORS

By: William M. Drohan/pw
William M. Drohan
Executive Vice President

86-952

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WRITER'S DIRECT DIAL NUMBER

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October 17, 1986

Director
Public Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street, NW
Washington, D.C. 20552

Gentlemen:

I am herewith submitting on behalf of Lincoln Savings and Loan Association ("Lincoln"), a California chartered association insured by the Federal Savings and Loan Insurance Corporation, comments on the proposed extension of the "Regulation of Direct Investment by Insured Institutions," 51 Fed. Reg. 32925 (September 17, 1986).

In addition, I am also submitting as supplementary comments copies of the following documents which relate to direct investments, previously submitted by Lincoln to the Federal Home Loan Bank Board ("FHLBB"):

1. Memorandum, dated July 7, 1986, from Arthur L. Liman to Lincoln Savings and Loan Association

2. George J. Benston, An Analysis of the Causes of Savings and Loan Association Failures, 1985

3. Letter, dated January 15, 1985, from Judith J. Wischer to Roberta White

PAUL, WEISS, RIFKIND, WHARTON & GARRISON

4. Letter, dated January 15, 1985, from Alan Greenspan to Roberta White

5. Memorandum, dated January 15, 1985, from Arthur L. Liman to Lincoln Savings and Loan Association

6. Letter, dated January 15, 1985, from George J. Benston to Roberta White

7. Letter dated November 1, 1984 from Alan Greenspan to Steven Goldstein

8. Letter, dated October 31, 1984 from George J. Benston to Steven Goldstein

9. Letter, dated July 16, 1984, from Arthur L. Liman to J.J. Finn

10. Letter, dated July 16, 1984, from Judith J. Wischer to Roberta White

11. Memorandum, dated July 13, 1984, from Arnold & Porter to Lincoln Savings and Loan Association

12. Memorandum, dated July 10, 1984, from Peter Fishbein to Lincoln Savings and Loan Association

Lincoln's position has always been that the FHLBB does not have the lawful authority to regulate or limit the substantive investment activities of state chartered savings and loan associations, and that the FHLBB has not yet provided a rational basis for its present and past attempts to limit direct investments.

Because of the complex and controversial nature of the Direct Investment Rule, and because of Lincoln's desire to have time to thoughtfully respond to the issues raised by the FHLBB in its September 17, 1986 notice, Lincoln requests an extension of the comment period and a public hearing on the proposed extension of the Direct Investment Rule.

Very truly yours,

Arthur L. Liman

PAUL, WEISS, RIFKIND, WHARTON & GARRISON

1285 AVENUE OF THE AMERICAS NEW YORK, NEW YORK 10019

DATE October 17, 1986

MEMORANDUM

To Lincoln Savings and Loan Association

From Arthur L. Liman

Subject FHLBB Proposed Rule: "Regulation of Direct Investment by Insured Institutions," 51 Fed. Reg. 32925 (September 17, 1986)

This memorandum sets forth our opinion as to the legal authority of the Federal Home Bank Board (the "Board") to adopt and extend its "Direct Investment Rule." The Board's new proposal would extend the expiration date of the Direct Investment Rule from January 1, 1987 to January 1, 1989. "Regulating Direct Investment by Insured Institutions," 51 Fed. Reg. 32925 (September 17, 1986). The Direct Investment Rule sets limits on the direct investments which can be made by institutions insured by the FSLIC. 49 Fed. Reg. 4873 (December 14, 1984).

In proposing to extend to the Direct Investment Rule, the Board has acted arbitrarily and without rational basis. The Board ignores the uncontradicted statistical evidence of three separate studies that demonstrate that there is no relationship between direct investment and association failures. Further, it ignores equally its own

supervisory experience which confirms the findings of these three research papers. The Board attempts to fill the resulting evidentiary void with a single study which is not even relevant to an evaluation of the Direct Investment Rule and with multiple repetition of an ipse dixit about its "supervisory experience" that can be based only on analytical confusion and factual ignorance. The Board's action stands as an archetypical example of arbitrary agency action.

In addition, as we fully explained in our memorandum of January 15, 1985 ("Jan. 15, 1985 Memo"), we believe that the Board lacked the legal authority to adopt the Direct Investment Rule. The Board now seeks to extend its life. In our view, the Board lacks authority to extend the operation of the Direct Investment Rule for the reasons stated in our previous memo and because, with respect to its current notice of extension, the Board failed to follow required procedures in proposing its amendment.[1/]

1/ We annex hereto copies of our earlier submissions stating our opinion that the Board's action in promulgating the direct investment regulation was unauthorized by law:

1. Memorandum, dated January 15, 1985, from Arthur L. Liman to Lincoln Savings and Loan Association.

2. Letter, dated July 16, 1984, from Arthur L. Liman to J.J. Finn.

I. The Direct Investment Rule Lacks a Rational Foundation, and the Board's Action in Proposing It Is Arbitrary

A. The Available Evidence Establishes that There Is No Connection Between Association Failure and Direct Investment

The Board's action in proposing to extend the Direct Investment Rule is arbitrary and irrational. The Board ignores the uncontradicted empirical evidence that refutes its contentions about direct investments and hides from the fact that much of this damning empirical evidence was produced by its own researchers. The Board's researchers, attempting to find some empirical support for the Direct Investment Rule, found the opposite -- that no such support existed. The Board's response demonstrates its irrational bias: it continued to pretend that its rule had some empirical basis while it attempted to sweep the contradictory findings of its personnel under the rug. Indeed, its notice extending the Direct Investment Rule does not even mention, much less discuss, this work.

Put bluntly, the two internal studies, see James R. Barth, Jr., R. Dan Brumbaugh, Jr., Daniel Saverhaft, and George W.K. Wang, "Thrift Institution Failures: Causes and Policy Issues," Conference on Banking Structure and Competition, Proceedings (Federal Reserve Bank of Chicago, 1985),

pp. 184-216; and James R. Barth, Jr., R. Dan Brumbaugh, Jr., Daniel Saverhaft, and George W.K. Wang, "Thrift Institution Failure: Estimating the Regulatory Agency's Closure Rule." (Unpublished paper, available from authors) directly contradict the Board's assertion that direct investments increase the probability that an association will fail. Both studies show that direct investments do not increase the probability that an association will fail.

The Board's failure to take these studies into account is the most arbitrary type of agency rule-making behavior. The conclusion is unavoidable: The Board has no answer to these studies, no empirical evidence to offer in opposition, and no rational defense for its Direct Investment Rule.

The Board's inability to counter the findings of its own researchers is not surprising. Those findings are consistent with the findings of the most elaborate and comprshensive study made to date that examines the relationship between direct investments and risks to the savings and loan industry and to FSLIC.2/ Professor George J.

2/ George J. Benston, An Analysis of the Causes of Savings and Loan Association Failures, Salomon Brothers Center for the Study of Financial Institutions/Graduate School of Business Administration, New York University, (Continued)

Benston, Professor of Accounting, Economics, and Finance, Graduate School of Management, University of Rochester, studied all associations that failed between January 1, 1981 and August 31, 1985, analyzed in detail each of the individual associations that failed between these dates and that had five percent or more of its assets in direct investments, and examined all FSLIC-insured associations (a total of 2,377 associations) over the period from June 30, 1981 through June 30, 1984 (hereafter, the "Benston Monograph"). His findings are the same as those of the Board's researchers, and they show that the Direct Investment Rule is not only unwise but also that it is positively harmful to both the savings and loan industry and the FSLIC fund.

The data in his study show that:

1. direct investments are "not significantly positively related to failure" (p. 72);

2. there is "no relationship between direct investments and [association] failures" (p. 119); and

3. "direct investments are not positively associated with FSLIC payments" (p. 72).

He concluded from these findings that:

(Continued)
Monograph Series in Finance and Economics, Monograph 1985-4/5 (1986).

> Direct investments -- defined as real estate held for development, investment and resale, and equity investments in service corporation subsidiaries -- were found to be neither a cause of failures nor responsible for higher FSLIC payouts at the associations that failed."

(p. 171)

Further, Professor Benston's study also demonstrated that direct investments tend to increase the profitability and net worth of associations and hence to protect the FSLIC fund. Specifically, he found that:

1. "there is reason to believe the direct investments have served to reduce the number of failures by increasing SLA [Savings and Loan Association] net worth and reducing their vulnerability to interest-rate risk" (pp. 122-123);

2. "direct investments, more so than other assets, considerably increased net worth" and hence lowered "the risk to the FSLIC" (p. 115);

3. "without direct investments, the average SLA would have had negative returns" (p. 94);

4. the "average returns on direct investments for all of the size groups [of association] are considerably above the returns on other assets" (p. 94);

5. "[t]hese higher returns [from direct investments] reduce the risk that an SLA might fail, causing resources to flow from the FSLIC" (p. 121); and

6. overall association "risk, as measured by the standard deviation of returns, is reduced by direct investments." (p. 99)

From these findings Professor Benston concluded that:

> "the regulation adopted by the FHLBB in 1985 that restricts direct investments to a maximum of ten percent of assets (unless the FSLIC-insured association obtains specific permission) appears to be counter-productive."

Id. at 171-72. His policy recommendations were soundly based on these clear findings:

> "SLAs should be permitted to use their comparative advantage in real-estate-related projects to make and manage direct investments. The investments referred to are those that are the subject of the study presented in Chapter II -- assets that are owned by SLAs, not loans that the FHLBB defines as direct investments (generally low-borrowed-equity acquisition, development, and construction -- ADC -- loans). Direct investments offer SLAs several advantages over other investments. First, they tend to provide SLAs with higher earnings than can be obtained from many other investments and operations, apparently because they allow SLA managers to use their skills and experience in making and monitoring real-estate-related investments. Second, direct investments have shorter durations than many other assets in which SLAs have invested; hence, they reduce the institutions' exposure to interest rate risk. Third, the returns on direct investments tend to be imperfectly correlated with the returns from SLAs' other activities; hence, the variance of returns tends to be reduced. All three factors reduce the risk imposed on the FSLIC."

Id. at 173.

Moreover, actual supervisory experience confirms the empirical findings of these three papers that failures of insured institutions are not in any way related to direct

investments. Scott Taylor, then Deputy Director of Liquidations for the FSLIC, has stated that, based on his supervisory experience, direct investments are unrelated to association failure. Taylor observed:

> For more than two years I have been in charge of liquidating failed FSLIC-insured institutions. During that time over 50 institutions were placed in receivership, and 26 were so badly scarred that they are being fully liquidated, with over $3.2 billion in historical assets.
>
> Those companies did not fail because of misuse of broader asset and investment powers, or because of direct investments in real estate. They failed because of fraud, incompetence and criminality which was not deterred or detected early enough, and which has little if anything to do with the ability to make direct equity investments or with broader asset powers.
>
> Despite strong assertions by some, I can see no basis to claim that direct investment authority is a cause of increased failure or a risk to the FSLIC. But if regulators do not examine and supervise adequately to prevent and deter wrongdoing, crime, fraud and incompetence will cause increased failures regardless of legal limits on investments. It is difficult to see the wisdom of barring the great majority of sound, well-managed savings institutions from safe and profitable business simply because regulators fail to prevent or deter others from crime.3/

The Board willfully ignores this supervisory experience. Together with the two studies conducted by the Board's researchers and Professor Benston's comprehensive

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3/ Letter, dated November 29, 1985 from Mr. Scott Taylor to Mr. George P. Rutland. (emphasis added) A copy of Mr. Taylor's letter is annexed.

analysis, it establishes that the Board's position is unsupportable, and that its proposed action is irrational.

B. The Board Presents No Evidence In Support of the Rule that <u>Is Entitled to Any Weight</u>

The Board relies on a single piece of research and a confused, inconsistent and entirely unsupported claim based on its "supervisory experience" to support the extension of the Direct Investment Rule. Neither piece of "evidence" is entitled to any weight.

The single study cited by the Board, prepared by the same researchers who prepared the two papers that contradict the Board,[4/] does not and cannot support the Rule. The study was not designed to answer the dispositive question, whether direct investments increase or decrease the risk to the FSLIC fund. The study examines only associations that had already failed and discusses the relationship between FSLIC payouts and direct investments at such failed associations. The study does not, and was not designed to, provide any evidence as to <u>why</u> any of these associations failed or

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4/ James R. Barth, R. Dan Brumbaugh, and Daniel Sauerhaft, of the Board's Office of Policy and Economic Research, "Failure Costs of Government-Regulated Financial Forms: The Case of Thrift Institutions" (cited at 51 <u>Fed. Reg.</u> 32926).

whether direct investments contributed to or helped delay the failures.

Most obvious, the study does not even attempt to consider the benefits that direct investments bring to associations or the number of associations which were saved from insolvency by profitable direct investments. Thus, it does not and cannot question Professor Benston's finding that direct investments are generally highly profitable, contribute to increased net worth, and help prevent associations from failing.

The Board's reliance on its "supervisory experience" is equally misplaced.

First, the Board's discussion of its supervisory experience is devoid of a single specific or ascertainable fact. On the face of its notice, the Board has failed to present any supervisory evidence to support extension of its Direct Investment Rule.

Second, analysis of available public records has repeatedly shown that the Board's supervisory experience does not support its contentions about direct investments. (Benston Monograph pp. 80-88) In the past, the examples Board personnel have attempted to utilize to show the dangers of direct investments have repeatedly proven to be irrelevant to that issue and to be examples of problems caused by fraud, mismanagement or certain kinds of loans. Based on the

Board's track record, there is no reason to assume that any relevant facts support the Board's conclusory assertions about the need for extending the Direct Investment Rule.

Third, the Board's analysis is confused and inconsistent. Even its bare and unsupported claim about its supervisory experience shows that the problem it perceives -- whether real or imagined -- is not true direct investments but rather "land loans and nonresidential construction loans." 51 Fed. Reg. at 32926.[5/] Evidence of the dangers of certain types of loans is not evidence of problems with direct investments. The Board's emphasis on the "misclassification" of land and construction loans further highlights the irrationality of the Board's approach. To the extent that certain types of loans are risky, the Board should regulate them and do so directly. "Misclassification" becomes a problem only because the Board refuses to regulate these types of loans directly and insists on lumping them together with true direct investments. In refusing to regulate based on the facts in the record, the Board is acting arbitrarily and irrationally.

5/ Indeed, its prior references to supervisory experience have consistently raised examples of associations that were harmed -- when fraud was not the culprit -- by various types of land and construction loans. (Benston Monograph pp. 80-88)

II. <u>The Board Lacks Statutory Authority to Promulgate or Extend This Rule</u>

The statutes relied upon by the Board in promulgating the original Direct Investment Rule do not give the Board the authority to prohibit conduct of state-chartered institutions that has been authorized by state law. Nothing on the face of the statutes or in their legislative history supports the Board's assertion of power to intrude into areas which Congress has historically and quite purposefully kept within the authority of the states.

A. <u>The Board Has No Lawful Statutory Basis for the Rule</u>

The various statutory sections on which the Board has from time to time attempted to rely simply do not authorize the Board's Rule.

Title 12 U.S.C.A. § 1730 does not authorize across-the-board regulation of practices deemed unsafe and unsound by the Board, but only permits case-by-case adjudications by the Board of unsafe or unsound practices. <u>See</u> Jan. 15, 1985 Memo, pp. 4-8, 13-19. Title 12 U.S.C.A. § 1725 is equally unavailing as a source of authority for this type of regulation. Section 1725 grants some rulemaking authority, but it does not grant the authority to by-pass the method expressly ordained by Congress to deal with unsafe and unsound practices -- individual case-by-case adjudications as mandated by

§ 1730. See Jan. 15, 1985 Memo, pp. 11-13, 21-23. Title 12 U.S.C.A. §§ 1424 and 1437 provide no authority for rulemaking with respect to the FSLIC fund. They are concerned with the Federal Home Loan Bank System. See Jan. 15, 1985 Memo, pp. 10-11, 19-21.

B. The Board's Rule Violates The Intent of Congress In Establishing the Dual Banking System

The Direct Investment Rule conflicts with Congress's intent that states exercise authority over the investment decisions of state-chartered institutions. See, e.g., West Helena Savings and Loan Ass'n v. Federal Home Loan Bank Board, 553 F.2d 1175, 1180 (8th Cir. 1977) (Congressional statutes "created and contemplate the continued existence of a dual system of savings and loan associations.").

This intent has remained firm in each successive piece of legislation Congress has passed, including the two major banking acts passed in the past six years. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132-93 (1980); Garn-St Germain Depository Institution Act of 1982, Pub. L. No. 97-320, 96 Stat. 1492 (1982). In both of these acts, Congress refused to tighten control of state institutions in the face of broader investment powers granted by the states. Both these Acts loosened restrictions on federal savings and loans; for

example, the 1980 Act eliminated geographical lending restrictions and the 1982 Act conferred broad new asset powers on federal associations. The Garn-St Germain Act, which established a special federal assistance program for troubled associations, imposed investment limitations only on troubled institutions which required the special federal aid. The Act again demonstrated that Congress intended to leave to the states the control of the investment powers and practices of healthy state-chartered institutions. See Jan. 15, 1985 Memo, pp. 28-30.

The basis for these conclusions are set forth more fully in the attached memoranda of law. As to the Board's lack of statutory authority and its violation of the dual banking system, see expressly Jan. 15, 1985 Memo. pp. 4-30.

III. The Board Has Followed Unlawful Procedures in Noticing the Rule

A. Inadequate Comment Period

In proposing this amendment, the Board has failed to provide a sufficient comment period. Given the controversial nature of the rule and the desire of affected institutions to respond fully and fairly, a thirty-day period is clearly insufficient. This is particularly true in light of the Board's specific request for comments on the continued need for the Direct Investment Rule after the Board's adop-

tion of a rule imposing higher regulatory capital requirements. 51 Fed. Reg. 32926 (September 17, 1986).

The Board's policy expressed in its "Rulemaking and Regulatory Simplification Notice," 45 Fed. Reg. 63135 (September 23, 1980), provides for at least a sixty-day comment period. A shorter period is permitted only if the Board states in its published notice the reasons why a shorter period is practical or necessary. Here, the Board's statement that a shorter period is permissible because the public interest requires prompt action neither states nor explains adequately the reasons for the shorter period. The Board does not state what public interest is served by prompt action, or how it is served by such action.

The Board states that a shorter comment period is sufficient because the Direct Investment Rule has previously been submitted for public comment. This makes no sense for two distinct and compelling reasons.

First, the Board has acknowledged that new regulations adopted subsequent to original promulgation of the Direct Investment Rule may substantially affect the operation, purpose, and need for the Rule. The Board has specifically asked for comments on the relationship between these various rules, and thirty days is simply not sufficient to allow adequate comments. This is particularly true in view of the Board's recognition of "the complexity of the

problems the Direct Investment Rule sought to address. [illegible]
Fed. Reg. at [illegible].

Second, the Board has also accepted the need to review carefully the operation and impact of the Direct Investment Rule. See [illegible] Fed. Reg. at [illegible]; [illegible] Fed. Reg. at 48756. The Board has announced the need for thorough empirical study. But the Board has failed to undertake that study. The Board may not now at this late date cut short the time required to do the work that the Board should have done.

The Board should extend the comment period [illegible] to make meaningful comment and analysis possible.

B. Failure to Meet the Requirements of the Administrative Procedure Act

Both the Board's regulations and the Administrative Procedure Act mandate that in proposing a rule the Board make reference to the source of legal authority for its action. 12 C.F.R. § 508.12 (1986); Title 5 U.S.C.A. § [illegible] [illegible]. No reference to such legal authority is made in this proposal. This omission is especially troubling given the comments the Board received when the Direct Investment Rule was first promulgated disputing the validity of the Board's legal authority to adopt it.

Further, the Board continues to fail to consider regulatory alternatives to the Direct Investment Rule. It is well established that an agency has a duty to consider

responsible alternatives to its chosen policy and to give a reasoned explanation for its rejection of such alternatives. See, e.g., Farmers Union Central Exchange, Inc. v. FERC, 734 F.2d 1486, 1511 (D.C. Cir.), cert. denied, 105 S. Ct. 507 (1984). There are several alternatives to extending the life of the Direct Investment Rule which the Board should consider and evaluate before taking the action it now contemplates.

The Board alludes to the fact that the Direct Investment Rule may no longer be necessary because of the adoption of the new Capital Requirements Rule. "Regulatory Capital Requirements of Insured Institutions," 51 Fed. Reg. 3365 (September 22, 1986). The purpose which the Direct Investment Regulation was meant to serve -- preventing allegedly risky investment practices and protecting associations and the FSLIC -- is now served by the Capital Requirements Rule. The Capital Requirements Rule will induce greater caution and help insure sound investment practices. Therefore, the Direct Investment Rule, if it ever served any useful purpose, has now been made redundant.

A.L.L.

Federal Home Loan Bank Board

1700 G Street N.W.
Washington D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

November 29, 1985

George P. Rutland
Chief Executive Officer
California Federal Savings
and Loan Association
Los Angeles, California

Dear Mr. Rutland:

I saw your recent remarks testifying before the House Banking Subcommittee on Financial Institutions Supervision. May I express my strong individual agreement with your view (supported by Dr. George Benston's recent study and the National Council's endorsement) that deregulation simply does not cause S&L failures.

For more than two years I have been in charge of liquidating failed FSLIC-insured institutions. During that time over 50 institutions were placed in receivership, and 26 were so badly scarred that they are being fully liquidated, with over $3.2 billion in historical assets.

Those companies did not fail because of misuse of broader asset and investment powers, or because of direct investments in real estate. They failed because of fraud, incompetence and criminality which was not deterred or detected early enough, and which has little if anything to do with the ability to make direct equity investments or with broader asset powers.

Despite strong assertions by some, I can see no basis to claim that direct investment authority is a cause of increased failure or a risk to the FSLIC. But if regulators do not examine and supervise adequately to prevent and deter wrongdoing, crime, fraud and incompetence <u>will</u> cause increased failures regardless of legal limits on investments. It is difficult to see the wisdom of barring the great majority of sound, well-managed savings institutions from safe and profitable business simply because regulators fail to prevent or deter others from crime.

Please accept my appreciation and support for your remarks.

Very truly yours,

Scott Taylor

Scott Taylor

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION RECAPITALIZATION ACT OF 1987 (H.R. 27)

Thursday, January 22, 1987

House of Representatives,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The committee met, pursuant to call, at 11 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the committee) presiding.

Members Present: Chairman St Germain, Representatives Gonzalez, Hubbard, Barnard, Wylie, McKinney, Leach, Wortley, Bartlett, and McMillan.

The Chairman. The committee will come to order.

This morning we resume hearings on efforts to recapitalize the Federal Savings and Loan Insurance Corporation and to stabilize the thrift industry.

The witnesses, Under Secretary of the Treasury, George Gould, and Federal Home Loan Bank Board Chairman Ed Gray, are key drafters and promoters of the administration's $15 billion plan to put new capital in Federal Savings and Loan Insurance Corporation.

The administration plan now faces a rival in a proposal being circulated by the U.S. League of Savings Institutions. The League plan is on a smaller scale and a shorter term and would require an earlier review by the Congress of the recapitalization and the efforts to stabilize the industry.

While it didn't come over on the Mayflower, the administration plan, now incorporated in H.R. 27, was heard in the committee in the last Congress, reported by the committee on September 23, 1986, and approved by the House on October 7, 1986, only to fail final enactment.

In announcing these early hearings—before the committee has even been formally organized—it was my intention that the critical issue of Federal Savings and Loan Insurance Corporation be heard out and determined in the House before more volatile issues promoted by various special interests muddied the waters.

But, judging from news releases bearing the letterhead of the executive branch, various meetings of lobbyists, and frenzied promotion of financial industry wish lists, it appears that some ha qualms about letting Federal Savings and Loan Insurance C tion issues be caught up in the lobbying storms of the mo of Washington's special interests. Let us hope that the

tion's decision to join the Mayflower lobbying combine does not create confusion about priorities in sorting out the problems of the financial community.

Prior to hearing from them I will call on Mr. Barnard for a short statement.

[The opening statement of Hon. Fernand J. St Germain follows:]

OPENING STATEMENT OF FERNAND J. ST GERMAIN
CHAIRMAN, COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HEARINGS ON H.R. 27,
"THE FSLIC RECAPITALIZATION ACT OF 1987"

JANUARY 22, 1987

This morning we resume hearings on efforts to recapitalize the Federal Savings and Loan Insurance Corporation and to stabilize the thrift industry.

The witnesses, Undersecretary of the Treasury George Gould and Federal Home Loan Bank Board Chairman Ed Gray, are key drafters and promoters of the Administration's $15 billion plan to put new capital in FSLIC.

The Administration plan now faces a rival in a proposal being circulated by the U. S. League of Savings Institutions. The League plan is on a smaller scale and a shorter term and would require an earlier review by the Congress of the recapitalization and the efforts to stabilize the industry.

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In announcing these early hearings---before the Committee has even been formally organized---it was my intention that the critical issue of FSLIC be heard out and determined in the House before more volatile issues promoted by various special interests muddied the waters.

But, judging from news releases bearing the letterhead of the Executive Branch, various meetings of lobbyists, and frenzied promotion of financial industry wish lists, it appears that some have no qualms about letting FSLIC issues be caught up in the lobbying storms of the most special of Washington's special interests. Let us hope that the Administration's decision to join the Mayflower lobbying combine does not create confusion about priorities in sorting out the problems of the financial community.

Welcome Mr. Gould and Mr. Gray. First we will hear from the Undersecretary.

Mr. Barnard. Thank you, Mr. Chairman.

Mr. Chairman, I want to reiterate again today the importance of these hearing and the early expediting of H.R. 27, which you have certainly taken under control.

I respect the concerns of those who would drastically modify or even oppose H.R. 27 as it is now written. Yet, we can tarry no longer, and I agree with you that it should be legislation in and of itself, that we should seek early resolution, and I say that for this reason:

1. We know the bonds issued under H.R. 27 would be acceptable to Moodys Rating Service at Triple A. I have the reports here that show it. As the Chairman's questions brought out yesterday, we know next to nothing about what happens under major alternatives with respect to marketability and, therefore, their entire workability.

2. We know the OMB, the CBO, and the GAO found H.R. 27's provisions acceptable last year—only after months of protracted negotiations to provide neutral impact on the Federal budget. We know no such thing about the major modifications we have seen to that plan.

3. We know we have a bill which is almost verbatim what this committee sent to the floor merely 4 months ago and that nothing has changed except that the urgency has increased.

4. We know the Washington Post's story of yesterday that the Home Loan Banks are close to refusing to honor Federal Savings and Loan Insurance Corporation guarantees is accurate. We have the memos to prove it. This development means the Home Loan System itself, is reaching liquidity shortage limits. That, in turn, means the Federal Reserve will be the last line of defense.

5. We know that indecision and self-deception can lead to the kinds of crises experienced on a State level by Maryland and Ohio. They no more thought it could happen there than we think it could happen here. But it did. This indecision at the Federal level means breaching faith with thousands and thousands of constituents in every congressional district.

6. We know that separate concurrent resolutions, like S. Con. Res. 72, of the 97th Congress, asserting the full faith and credit of the U.S. stands behind Federal Savings and Loan Insurance Corporation, are not binding, are not authorizations, and are not appropriations. In short, they are merely intent.

7. We know the Home Loan Bank System does not even have totally clear legal authority to use its ultra-emergency one percent of deposits assessment authority, as the hearing records of the 99th Congress demonstrate.

8. I know—and everybody who reads the money rate columns knows—the basic statistical runs in the proposed alternative are just inadequate to support the assumptions of that alternative. For just one example, all the alternative scenarios, starting on page 51 of the U.S. League of Savings Institution's Task Force report, assume an 8 percent long term borrowing cost on the zero coupon bonds which decrease over the long period of 20 years. That is just not realistic, even if we could get them out and sole tomorrow in a low interest climate. The rate has got to be at least 9 percent.

Finally, I have great misgivings about the forebearance program suggested in testimony yesterday. The Government Operations Committee put out a detailed study of appraisal practices in October of last year. It clearly showed funny evaluations of real estate are largely what got us into this mess in the first place. However, gotten into it, I see nothing short of a calamity which cannot be contained to Texas if we don't go along, for a limited period, by statue, or better, convince the Federal Home Loan Bank Board to go along by regulations. Statutes are hard to modify and regulations are more flexible.

Finally, I would hope that a policy of forbearance would be enough to halt the need for a Berlin Wall lockup.

People will stay if they get soft accounting treatment. But more importantly, new capital will come in if Congress does not signal it thinks the thrift industry is so dead that it has to pass a statute to keep people in it.

There are those who advocate merging the Federal Savings and Loan Insurance Corporation and Federal Deposit Insurance Corporation might or might not be right—eventually. However, the project they propose is far beyond the horizon of immediate actions which the figures indicate is mandatory. Talking about merging the funds, in reality, means reworking hundreds of pages of statutes and incredibly controversial issues when, in truth, we must be ready to go to rules right after the presidential work period.

Finally, I have put away my ornaments and tinsel. I hope everyone else will do the same. Now is not the time for decorating a Christmas tree, it is time to build a lifeboat. If we do not, the consequences to the reputations of all of us are getting very clear.

Thank you very much.

[The prepared statement of Mr. Gould can be found in the appendix.]

The CHAIRMAN. At this time we will first hear from Under Secretary Gould. We will put your entire statement in the record and you may proceed.

STATEMENT OF GEORGE D. GOULD, UNDER SECRETARY FOR FINANCE, DEPARTMENT OF THE TREASURY

Mr. GOULD. Thank you very much, Mr. Chairman, for having me. As you requested, I will limit my oral remarks.

I am delighted to have this opportunity to testify on our plan to recapitalize the Federal Savings and Loan Insurance Corporation. We are greatly encouraged by your early hearings, particularly because there is an urgent need to address immediate safety and soundness concerns.

Recapitalizing Federal Savings and Loan Insurance Corporation is our top priority. For the reasons I outline in my testimony, we think the need is pressing and the time to act is now.

When that essential safety and soundness issue can be put behind us, we stand ready to work closely with you on other competitive and consumer issues. We believe a comprehensive restructuring of our financial services industry is overdue.

As Treasury Secretary James Baker stated last week: "America needs to reposition itself on the leading edge of the financial services world."

A little over 1 year ago, Congress asked us to devise a plan to come to Federal Savings and Loan Insurance Corporation's rescue. We responded early in 1986, because we are no less concerned about the safety and soundness of the public's insured savings.

The problems of the thrift industry and Federal Savings and Loan Insurance Corporation's dwindling reserves are well known, with highlights contained in my written statement.

With that as background, and working with the valuable assistance of the Federal Savings and Loan Insurance Corporation, the Federal home loan banks, and members of the industry, we devised a plan which is based on two fundamental points.

First, it is truly a self-help plan on the part of the industry; no taxpayer money or government guarantees are involved. Taxpayers will not be required to bail out an industry that with some measure of sacrifice over time can help itself, and where the healthy institutions are enjoying record levels of profit.

Second, our recap plan has sufficient resources, available when necessary, to meet the real problems which exist today. These are not theoretical or prospective problems; rather, they are an accumulation of the present and the past and involve safety and soundness for depositors with almost $900 billion in savings.

I am pleased to note that our plan has been endorsed again by many responsible people in the thrift industry, including presidents of the Home Loan Banks, the National Council of Savings Institutions and the New England League of Savings Institutions. As you know, it was also passed by both Houses of Congress last year.

While some people may think our plan is complex, the concept really is quite simple. Money is needed now and over the next few years in an amount well beyond that which is available either from Federal Savings and Loan Insurance Corporation's existing resources or from what it is reasonable to expect from industry assessments over the same period of time. Any home buyer who needs a mortgage understands that concept well. The actual financial structure we have used to accomplish the concept is rally just detail—but detail that works.

As you know, our plan also meets CBO requirements—with GAO concurring—to be considered an offsetting collection rather than a Federal borrowing for budgetary purposes.

You have heard testimony about an alternative plan by the U.S. League of Savings Institutions. Let me take just a moment to comment on what we consider to be a largely "pray as you go" approach.

If you start with just the simple arithmetic of their financing scheme, you will see that the numbers don't add up to meet what we consider to be a responsible level of resources needed for Federal Savings and Loan Insurance Corporation's existing caseload. Also, the league's own worksheets reveal that it is a far less efficient way to raise funds for Federal Savings and Loan Insurance Corporation. The league would raise only ⅓ of the money for over ½ of the cost of our plan.

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Indeed, even to get as far as they go, there has been a substantial shift of responsibility for the industry to the Federal Home Loan Bank Board Bank System, a government sponsored enterprise and an agency borrower with a $4 billion line of credit from the U.S. Treasury.

Their plan—like a bad check—ought to be rejected by Congress due to "insufficient funds."

Let me make one other observation. Based on my personal experience, the U.S. League bonds are not salable, except at prohibitive rates of interest, unless, of course, they are meant to be sold with some backing of the Federal Government.

We have devised a plan which specifically avoids any Federal guarantee and whose bonds are salable because of the internal structure. Our purchase of zero coupon bonds matches against the principal due and thus guarantees its repayment. We do not believe our bonds need a Federal connection to be deemed credit worthy.

Simply put, our bonds will sell at a reasonable rate on their own merits. The U.S. Leagues bonds, if salable, would be terribly expensive.

I would be happy to comment further on their plan during the question and answer period.

Mr. Chairman, before I close, let me take a moment to touch on a subject that I understand came up in your hearing. Some people in and out of government have suggested that the solution to Federal Savings and Loan Insurance Corporation's funding problems is to merge the two Federal Deposit Insurance Funds. I want to be certain to clarify Treasury's view on this subject, because there may be some confusion.

First and foremost, let me assure this committee that the Treasury Department has no hidden agenda to merge the funds.

It is true we have stated that failing substantial success to enact our Federal Savings and Loan Insurance Corporation recap plan, the concept of merging Federal Savings and Loan Insurance Corporation and Federal Deposit Insurance Corporation comes ahead of using taxpayer money, which would be a last resort only to prevent systemic problems for depositors.

It may be useful to clarify precisely what this merger concept would mean:

There still would be two funds, not one comingled entity. The merger would be at the regulatory level.

Money still would be needed up front and still would have to be borrowed. Federal Deposit Insurance Corporation's reserves would not be available, except possibly as a backstop for an Federal Deposit Insurance Corporation guarantee of the thrift fund borrowings.

The S&L industry still would not avoid the costs, a premium differential is inevitable.

Debate and negotiation would be time consuming and extremely difficult, contributing to uncertainty in the marketplace.

Moreover, if the Federal Savings and Loan Insurance Corporation is merged with the Federal Deposit Insurance Corporation, the Federal Deposit Insurance Corporation's reserves should not be made available to resolve Federal Savings and Loan Insurance Cor-

poration's problem cases both because they represent accumulated assessments on the commercial banks and they are needed to reassure depositors of those institutions.

Incidentally, there is also an unfavorable budget implication. The present reserves of the Federal Deposit Insurance Corporation have already been scored as a budget receipt as they were accumulated Thus, their use, unless offset by an equal amount of new receipts, would be a direct hit to the Federal budget. Our plan, however, would bring in $15 billion as budgetary receipts that will offset Federal Savings and Loan Insurance Corporation's case resolution costs and thus would not increase budget outlays.

Merger of the funds has become a diversionary tactic for some wealthy members of the S&L industry who don't want any legislation this year. We are all well aware that a merger would be legally and administratively complex, and a political nightmare. The bankers would resist vigorously. So would small and medium sized S&L when they realized the implications for this industry.

I urge the Congress to reject calls for further delay, more study, and grand schemes that fall short of providing Federal Savings and Loan Insurance Corporation with the necessary funds.

In the final analysis, no one in government wants to see depositors standing in lines, like they did in Ohio and Maryland. We, therefore, urge you to pass our recapitalization bill quickly and cleanly. We stand ready to assist you in any way we can, and again applaud you for your early attention to the important issue.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Gould can be found in the appendix.]

The CHAIRMAN. Thank you.

Now, we will hear from the Chairman of the Federal Home Loan Bank Board, Mr. Gray. We will put your entire statement in the record and you may proceed.

STATEMENT OF ED GRAY , CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. GRAY. Thank you, Mr. Chairman, members of the committee.

I appreciate the opportunity to join with you here in this important hearing.

This is the fourth calendar year I have come before you in similar proceedings as Chairman of the Federal Home Loan Bank Board, to share my views on the condition of the savings and loan industry and to present recommendations for strengthening the national thrift system.

The thrift system itself, continues to enjoy the paradoxical distinction of enjoying the best of times and the worst of times. One the one hand, the vast majority of the thrift industry is very profitable. After tax earnings for the roughly four-fifths of the industry which is profitable, were $6.9 billion in the first three quarters of 1986, the latest comprehensive reporting period. This is just short of the earnings performance registered by the profitable sector for all of 1985. In summary, the profitable segment of the industry—again, the vast majority of the thrift institutions—is healthy, and many, many institutions are robust performers.

On the other hand, the unprofitable one-fifth of the thrift industry is very unprofitable, but more particularly the failing sector of the savings institutions business.

The Federal Savings and Loan Insurance Corporation, the deposit insurance arm of the Bank Board, is called upon by law to stand behind the insured accounts of savers who have placed their funds in the Nation's more than 3,000 Federal Savings and Loan Insurance Corporation insured savings institutions. These savings accounts, which amount to some $890 billion, are today backed by a deposit insurance fund with less than $2 billion in primary reserves, the lowest ratio of such reserves to deposits ever.

Moreoever, the thrift deposit insurance fund's reserves continue to deteriorate. Absent prompt action by the Congress to help us remedy this situation, the reserves will continue to fall, without the prospect of adequate replenishment, to even more alarming levels in the months ahead.

Needless to say, this situation presents all of us with a fundamental challenge—and yes, obligation—which must be dealt with soon. Nothing, simply nothing, is more important to the maintenance of a sound financial system than the maintenance of public confidence in it. The thrift system, which is an integral part of the Nation's overall financial system, is no exception.

None of us can afford to forget the nature and consequences of the loss of public confidence which occurred in connection with the Ohio and Maryland thrift crises. The public did, in fact, lose confidence in the backup mechanisms which had been instituted to safeguard the funds of depositors in the Maryland and Ohio systems. And the repercussions of these thrift crises were felt, as you will recall, far beyond the borders of the two States involved.

We also must address the issue of public confidence in the Nation's federally insured thrift system, in a decisive and expeditious manner, which conveys maximum certainty to the public that the problems of the thrift deposit insurance fund are being dealt with in a way which merits their full confidence in the thrift system, now and in the future.

For a year and a half now, I have been saying the thrift insurance fund must be recapitalize. Even earlier, at the beginning of 1985, the Bank Board exercised its full statutory authority to raise insurance premium contributions from Federal Savings and Loan Insurance Corporation insured member institutions to the maximum permitted by law.

It became clear to me in the summer of 1985 that these insurance premium resources would not be enough to maintain the level of reserves needed for the Federal Savings and Loan Insurance Corporation to truly meet its obligations.

Working with the Treasury, the Bank Board developed a plan to recapitalize the insurance fund in the first several months of 1986. This plan was presented to this committee last April and the basic framework was, in fact, adopted by both the Senate and House in the waning days and hours of the 99th Congress, although no conference action was taken thereafter to resolve the differences.

This plan, which would provide some $32 billion to the thrift fund, if needed over the next 7 years, was reintroduced in both Houses several weeks ago.

The plan, which is described in the statement I sent you yesterday, would, if adopted, enable us to begin the process of restoring public confidence in the thrift system right away by sending a clear signal to all that there will be tools and requisite financial resources in place and available over time to restore the health of the thrift fund and being to put many of our problems behind us.

I want to emphasize that the Bank Board-Treasury plan will not require the infusion of any taxpayer dollars. It is entirely self-funded by the thrift system.

We are estimating that the financial resources which will be needed to resolve terminally ill thrift cases—cases that we now know about—will be some $19.5 billion. We also have included another $4 billion in our overall estimate of $23.5 billion to cover what we consider to be borderline cases which could well require Federal Savings and Loan Insurance Corporation assistance in the next 5 to 7 years. This leaves another $9 billion, which would be available if needed, for contingencies over the next 7 years.

Again, the basic outlines of our plan, which both Houses saw fit to adopt late last year, would, in my view, provide enough money to deal with severe thrift problem cases over time, sending a clear signal to the public that improved public confidence in the thrift system is fully merited.

This would have the very beneficial effect of improving depositor perceptions of the thrift insurance fund itself and therefore, reducing interest costs the thrift industry is now paying for deposits, thus further enhancing opportunities for profitability.

A study we completed last year showed that the thrift industry as a whole was paying at least $4 billion a year more than necessary for deposits, precisely because of market concerns about troubled thrifts and negative perceptions of the Federal Savings and Loan Insurance Corporation's strength, deriving from its weakened conditions.

The spillover effects of perceptions of a weak thrift insurance fund, which is incapable of resolving severely troubled, terminally ill thrift cases, because the fund doesn't even begin to have the financial resources to do so, directly contribute to higher than necessary costs of operations at all thrifts, healthy or unhealthy.

Today, the 347 most severely troubled thrift institutions in our system are losing, on an operating basis, roughly $6 million a day, or $2.2 billion a year. This annual loss is more than the insurance fund's entire annual income, and is $350 million more a year than the Federal Savings and Loan Insurance Corporation is collecting in insurance premiums.

Our recapitalization plan would enable the Federal Savings and Loan Insurance Corporation to begin to get at this problem by providing the resources we need to resolve such cases early on.

We will soon be implementing a variety of measures to improve the thrift system's ability to handle Federal Savings and Loan Insurance Corporation resolutions as efficiently and as cost effectively as possible, using the expertise and organizational resources of the entire system in a fully coordinated manner.

I would note on page 10 of the written statement that I submitted yesterday, we enumerated these measures. In so doing, we will be using the expertise and the full organizational resources of the

entire thrift system in a fully coordinated manner. Nothing is more important to us in the Federal Home Loan Bank Board—Federal Savings and Loan Insurance Corporation System than to safeguard the monies in the insurance fund in the Federal Savings and Loan Insurance Corporation case resolution process.

The Bank Board-Treasury recapitalization plan has the attribute of providing, over a known period of time and in the most cost effective manner, the greatest amount of certainty that the thrift insurance fund will have the financial resources it needs to protect and strengthen the thrift system, without the use of taxpayer funds, while at the same time, improving public confidence in the system.

During these past few years, the strains on the thrift system itself have been enormous. I mentioned time and again to this committee and in many of the speeches that I have made to the industry over time the system was, frankly, not prepared to deal with the vicissitudes of a deregulated thrift operating environment.

The Bank Board has made very considerable gains in its efforts to modernize and strengthen the regulatory oversight apparatus and process. The progress which has been made must continue and be further strengthened. Without the commitment and resolve necessary to assure that safe and sound operating practices are observed and enforced throughout the thrift industry, and without the appropriate discipline necessary to assure that this does in fact occur, recapitalization of the thrift insurance fund, no matter how much money it provides, cannot truly succeed in its intended goal: that of getting the difficult problems we now face behind us.

I am committed to the goal of making recapitalization work by carrying out the continued vigilance and regulatory discipline which that commitment entails on our behalf, and on behalf of the American public. I look forward to working closely with you in the weeks ahead to achieve common objectives.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Gray can be found in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman.

The chair would like to make an observation. This committee, and the House, on one occasion did indeed pass or adopt the Federal Savings and Loan Insurance Corporation recapitalization. No one, I venture to say, on this committee would, if asked, reply that this was a perfect piece of legislation and the best that could be devised. So, I would caution the witnesses today not to wave the flag as one that everybody should follow.

It was done on a time constraint. There were many, many items that came to bear upon us. We felt—I think many of us felt that it was the best available at the time. That does not mean that we should now put blinders on, and since it was passed last year it should just go that same way with each dotted "i" as we did last year.

Mr. Gould, your background, as I recall it, is that of an investment banker, is that not correct?

Mr. GOULD. Generally speaking, yes sir.

The CHAIRMAN. You were in the firm of Lufkin and Jenrette, correct?

Mr. GOULD. Yes. I spent 25 years in Wall Street.

The CHAIRMAN. A very distinguished career.

Now, I appreciate your ability and have no reason to doubt your veracity. By the same token, I think you agree the reason you have a lot on investment firms is that there is much competition, and there are other reasons some investment banking firms will take on an issue that others won't. They reach different conclusions, is that not correct?

Mr. GOULD. Yes, that is what makes markets.

The CHAIRMAN. That being the case, I think you agree that we indeed should be certain that we have the opinion not only of yourself, or your statement—you stated that in your opinion this recap plan would be salable. Now, we have attempted, Mr. Gould, to find some investment bankers to come in and testify on this. We have not been able to. No one has come forward, no one has volunteered. Even further, those we have asked have not agreed to testify.

Could you give us a list of investment bankers that we could have to come in and to testify and to give us their opinion of this plan?

Mr. GOULD. We would be happy to furnish you with a list, Mr. Chairman, of people that we think would by background and market experience, would have opinions worth listening to.

The CHAIRMAN. Not only opinions, but what it really comes down to is the fact that unless you have the investment bankers who are going to say yes, we are going to take this and we feel that we can dispose of these in the marketplace, then the plan has no validity.

Mr. GOULD. Well, the bonds had to be sold publicly, so we will need someone to do that. I am sure you understand, as the organization of the Home Loan Bank system, they do indeed have a financing office in New York, they have some $87 billion of bonds outstanding, so they are in contact with the street and with selling organizations, and I would also suggest that their opinion should carry some weight here. We have had some people look at this last year and we have received a series of letters from investment bankers as to the plausibility of our plan.

The CHAIRMAN. Could we have those for the record?

Mr. GOULD. Yes sir, you certainly can.

The CHAIRMAN. Because perhaps we would call upon some of these people to come in and testify.

You know, we are not asking, I am not asking anything of this plan and of you that I didn't ask of our witness yesterday. They submitted a plan that included zero coupon bonds. I said, well, on what do you base your opinion that these are salable, and they said they didn't have it yet. So I said, you had better submit it.

Mr. GOULD. As you probably are aware, Mr. Chairman, we submitted to you last week the names of a number of investment bankers. I would be happy to submit them again if you would like, sir.

The CHAIRMAN. Staff informs me that we were indeed given a list of five individuals by Treasury.

Mr. GOULD. Sir?

The CHAIRMAN. Treasury gave us a list of underwriters available to respond to market questions. You gave us five names.

Mr. GOULD. Yes sir.

The CHAIRMAN. The problem is it is like LeRoy says. LeRoy says he doesn't want to go into the ball game. No one wants to come in the game, they want to sit on the bench. We would like them on the field. Maybe you could help us to convince them to come in and tell the public at large in the sunshine, under the lights of the committee, what they feel about the plan and how adequate they feel it is. Would you help us?

Mr. GOULD. I would be delighted to help, Mr. Chairman.

May I take a moment to comment on one of your earlier statements—that the fact this is perhaps not the world's most perfect plan. We have no pride of authorship——

The CHAIRMAN. I bet you agree with that.

Mr. GOULD. Well, nothing is perfect really. When we start out as we we do to try to blend the concerns and the understandable self-interest of a variety of people, we tried to get a plan that faced down the special assessments of the industry. For 5 years we tried to create a plan which utilizes some of the capital of the Home Loan Bank System but did not unduly impinge on the credit of that system when it sells its bonds in the marketplace.

We tried to do it in a way that kept even the implied involvement of the Federal Government out of the picture, and we tried to do it in a structure—this is important—that raised enough money to handle the problem as best we could define it.

When you start from a variety of different premises, one I think inevitably arrives at a plan which would not be perfect in the eyes of those parties, but does indeed fit the basic criteria laid down, and we think this plan does it.

Earlier the U.S. League of Savings Institutions had a plan which I gathered they abandoned, because it clearly did not provide enough funds, which they termed pay as you go. Now, I can in 5 minutes give you a true pay as you go program here, that involves no borrowing and no future interest costs, but I think the industry would very quickly tell you that this assessment needed roughly ¼ of 1 percent a year of deposit each year for the next 4 years, would be simply too great a burden for them to shoulder.

So, yes, there are various ways that one can construct a plan. Yes, there are other things that certainly should be given due process and should be looked at, but we have to, I think, Mr. Chairman, come back to what we are trying to accomplish: Enough money to solve the problem as it is known; no involvement of taxpayers; money being drawn down as it is needed so no one gets burdened up front with more than might be necessary later; and industry based.

If you want to establish other criteria, surely you could come up with a different structure.

The CHAIRMAN. Mr. Hubbard.

Mr. HUBBARD. Thank you, Mr. Chairman.

To Mr. Gould, on page 7 of your statement, you call the U.S. League of Savings Institutions new recap plan a phony proposal and you say the League is trying to stop a real recapitalization of Federal Savings and Loan Insurance Corporation. Are you willing to suggest that the League proposal is designed to ultimately necessitate a taxpayer financed bailout of the thrift industry?

Mr. GOULD. Well, sir, I think there are a number of agendas operating concomitantly. Here I think there are certainly part of the League that are playing a giant game of chicken with the administration and with the Congress. You know, we can just delay everything long enough, there won't be any crisis, and if we are going to have to protect $900 billion of deposits there so suddenly, in that crisis, money is appropriated, and if the money is appropriated, the industry doesn't have to pay themselves.

I am not saying that is a universal agenda for the industry, but there is certain parts of that would be happy to embrace such a movement. Indeed, they have publicly to me, and to others, cloaked that under the banker that the Government caused this problem by prematurely—their word—prematurely directing interest rates. If the Government caused the problem, the Government ought to pay for the problem.

I would suggest in this job I have heard that about a hundred times from different groups so far, that when things are going well, that is, their money, and when things are going badly, the Government should step in and pick up the tab. A constant refrain. We have heard it in farm credit, we have heard it in a number of instances, and I think that is a refrain that should be rejected, particularly since there often is this same line of argument come from the people who have most profited from their S&L franchises.

Mr. GRAY. Congressman, can I add to that?

Speaking of the U.S. League plan—and I certainly have no aversion at all to any good faith attempt to come up with various alternatives to financing basically our problem—but as I have looked at the U.S. League of Savings Institutions plan, I cannot help but conclude that it is very inefficient, to begin with, in that under their plan the financing corporation would issue $32 billion in zero coupon bonds, and these would be 20 year bonds for which there is no current market.

Certainly Mr. Gould could comment on that, but theoretically even if there were, the interest costs on these bonds would be substantially greater than what the U.S. League says. They have put a figure of 8 percent on that, but $32 billion in terms of bonds that have to be paid for, which only produce $5 billion in the first 2 years, is a tremendous obligation for somebody to have to pay.

So, if we assume that there could be a market and even though the interest costs would be tremendous, the fact is that the debt service on those bonds would have to be paid by the FLBs. That would amount roughly, at least in the beginning, to about $275 million a year. That $275 million would over time be invested in the long term and these investments would produce some $16 billion. Then you have $16 billion that has to be repaid, because the Federal Home Loan Bank Boards are really, through their investments, and the investment income that would ultimately occur, get only $16 billion. So there is another $16 billion obligation that has to be met over time.

It is quite easy to see that $16 billion would require for a longer period of time. Just for the $5 billion that you get up front, this would require the imposition of the special assessments or the maintenance of the current special assessments for, we think at least 5 years, if not more—that is only for $5 billion—we are talk-

ing about providing as much as $15 billion in the Treasury-Bank Board plan.

Now, if you can't sell 20 year, if you can't issue for all practical purposes 20 year zero coupon bonds efficiently, then what about 30 year zero coupon bonds? At 30 years, the League plan would still produce $5 billion, but the obligation that would have to be repaid in the end over 30 years would be $80 billion. Somebody would have to pay that. If it were 30 year bonds, the Federal Home Loan Bank Board contributions to service the debt and the investment which would ensue, would yield $35 billion. But that is $35 billion that could be repaid on the 30 year bond, but what about the other $45 to take care of the $80 billion obligation? Where would that money come from?

I could see a special assessment imposed on the industry for many, many years to do that. So, the problem here is with the U.S. League plan, as I see it—I am trying to be constructive in my comments—is that it is unfortunately very inefficient, but it leaves a tremendous amount of money that has to be repaid by someone and if we assume the taxpayers are going to pay it, then the costs to the industry over the bonding period are going to be just absolutely immense, if not counterproductive.

Mr. HUBBARD. Thank you.

The CHAIRMAN. Time has expired.

Mr. GOULD. I was trying to explain the difference.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

I appreciate the testimony of both the witnesses this morning. It is clear we have a financial bombshell in the industry comparable to the international lending problems of the larger banks, if not more so.

It is also clear that the Congress is going to have to act. I am not sure that it has been made as clear as it should be that when you have a fiscal crisis it is difficult to borrow on one's way out of it and the Treasury-Federal Home Loan Bank Board plan is largely a borrowing rather than a recapitalization, although there are some recapitalization components. That means it is a step beyond smoke and mirrors, but not a terrible large step.

But I would like to stress, as Mr. Gray did in his written testimony, that the quid pro quo is that I think Congress ought to be concerned within the strongest of the quid pro quos, as we look at the increasing liquidity of Federal intervention, is to seek strong regulation and the sternest of regulation I think can't be underestimated, particularly the need for recapitalization within the entirety of the industry. Particularly because it is only through capitalization requirements that one can have any containment of the issue of growth and growth can be very profitable, particularly in a decelerating interest rate environment in the industry. But it can be very reverse under reversed circumstances, and I know very few economists that are not suggesting we may well be having a little more inflation in the years which produced record profits for 80 percent of the industry, may well turn around.

So that brings me to the dilemma that I see, that relates partially to Federal regulations and partly to States. Some of the States have basically gone bonkers in terms of powers given some of the

thrifts. This is of enormous national significance, because even if one represents a State like I do, with fairly tough regulatory standards, many of our deposits are taken out of the State to assist those institutions in the less strong regulatory environments and that raises this whole issue of what powers are being offered by States and whether there ought to be quid pro quos in the legislative environment as well as in the regulatory environment.

We have all observed that at the Federal Home Loan Bank Board there has been some controversy on whether direct investment ought to be restrained and the current rules extended. I personally find it somewhat scandalous that the current rules are as weak as they are, and to have a controversy based upon extending unbelievably lax standards is unbelievable and I would just simply suggest that, Mr. Chairman, as we take a new look at that, one of the areas we ought to look at again is the idea that maybe in a statutory environment some of these direct investments that are allowed to be made by relatively weak institutions, and that are largely to be made in the future in less ideal interest rates environment, ought in and of themselves to be curtailed.

Would you care to comment on that, Mr. Gray?

Mr. GRAY. Well, I have been, as you know, Congressman Leach, bringing these issues before this committee and the Financial Institution's Subcommittee for several years now, almost with a kind of messy anti-fervor. I guess with you, that the direct investment regulation is not as strong as it should be and I have stated that on a number of occasions. It happened to be the best I could do back when we adopted it, and at the very least, I believe it ought to be extended, if not by the Bank Board, by the Congress itself.

I would prefer that it be extended, as weak as it may be, by the Bank Board, to maintain flexibility, but if that can't be done, I think in my own view, given my very strong concerns—and I spent a good deal of my written testimony, which I hope you had the opportunity to read—to make many of the points that you have made.

Safety and soundness and regulatory disciplined, particularly given our experience over these last few years, is absolutely necessary so far as I am concerned. As I said even in my opening statement, this recapitalization plan, imperfect as it might be, is not worth the paper it is written on if we cannot bring back to this industry the kind of discipline to protect this insurance fund which we and the American taxpayers, have to stand behind.

I note, by the way, that the Federal Reserve has proposed a regulation that says that only a very limited amount of capital can be set aside for making direct investments in a holding company affiliate not in the insured institution, for that matter. So it is far more restrictive than ours is.

The CHAIRMAN. I am going to have to ask you to be fair to the other members of this committee, and if you want them to look favorably upon you, if you are going to impose on their time the way you are doing, you see, if you are going to give 20 minute speeches on each question, then a lot of these members are going to say what kind of fellow is this.

Mr. LEACH. Mr. Chairman.

Mr. GOULD. Mr. Chairman.

The CHAIRMAN. The time of the gentleman from Iowa has expired.

Mr. LEACH. My time has expired. If I could make a 15 second comment, simply to stress when the point the gentleman made, relatively speaking, when banks are much tougher on the regular savings and loan industry, are a better reserve funds, and secondly, that the rules of the savings and loans industry currently amount to a government guarantee of high flyers.

This Congress has an obligation to look at it if the Bank Board fails to, but even if the Bank Board acts, this Congress ought to look at it in addition.

The CHAIRMAN. Mr. Barnard.

Mr. BARNARD. Since I expressed myself in my opening statement, I will waive my questions at this time, but I will be back for a second round.

The CHAIRMAN. Mr. McMillan.

Mr. MCMILLAN. No questions.

The CHAIRMAN. Mr. Price.

Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman.

Secretary Gould, and Mr. Chairman Gray, welcome. Thank you for your testimony.

A question that you may have addressed in your testimony that I missed, but the question I would like to first pose is, how do we keep healthy S&Ls from bailing out of the Federal Savings and Loan Insurance Corporation savings banks and seeking insurance from the Federal Deposit Insurance Corporation. How do we go about doing that?

Mr. GRAY. Well, first, I think through recapitalization we improve public perceptions of the system as a whole.

Mr. CARPER. What we are hearing from some spokesmen from the S&L industry is that what is going to happen faced with the likelihood of anticipation of special assessments over a lengthy period of time rather than have to face that, they will decide to become insured elsewhere.

Mr. GOULD. Well, our experience is a little different, at least from what we have seen in terms of movement toward savings institutions being acquired, for example, by bank holding companies. This is a bit complex issue but some of the bank holding companies that have wanted to do so because they can achieve as a result instant penetration of the market. I certainly understand that.

The problem is, if we are going to have that kind of recapitalization plan, there has to be a way to keep it viable. So we have discussed the need for authority to deal with the exit fee issue, merely to keep the recapitalization plan viable, because it is a long term proposition to get money up front, and it has to be paid back. You have to have the premium stream from insurance premiums to make sure that you can meet the servicing costs of the debt that is involved, and if our recapitalization plan we are phasing out over a 5 year period, the special assessment in any event, which I think is basically the approach that even the U.S. League takes, they understand that there has to be a phase out of this if at all possible.

Mr. CARPER. Thank you.

Mr. Gould.

Mr. GOULD. Well, we have said before that we are not convinced that there is a major movement potentially ahead of us out of an industry where the franchise in many ways is far more expansive than that of the commercial bank and that those people who have prospered in the S&L industry with their S&L franchise may or may not be that anxious to exit and become a bank and be part of the FDIC.

However, if there are people who qualify and those are tough qualifications, we are not convinced that say more than 15 percent of the deposits in this industry are capable of making that movement today and meeting FDIC standards. But if they do feel they would now like to become some other animal we do not favor on the basis as it is really just un-American, to say you cannot leave what you are doing and go do something else.

But we have been supportive in concept of the idea that if you are going to leave and go somewhere else with the integrity of the plan, you should pay an exit fee. One of the equitable aspects of paying an exit fee is that one of the reasons FSLICs are in trouble is that these people have been undercharged in the past. As it turned out the inherent risks in the industry have been greater than 1/12 of 1 percent assessment a year would pay for. So an exit fee is nothing more than saying you have enjoyed the advantages of this franchise but you were undercharged in the past and before you go to some other metamorphosis we think only appropriate that you pay an exit fee.

Now, I think one other thing is very important, if I may say so, Mr. Carper. If we can get this industry settled down so that people in the industry know what the ground rules are which is one of the reasons that we object to only a 2-year and inadequate refinancing of the U.S. League. If we can just say this is what you are faced with ahead these are the rules, then I think you will keep a lot more people in place because they won't be fleeing some amorphous uncertainty in future years.

Mr. CARPER. Thank you.

I understand that each of you have a somewhat different view on what the future of nonbank banks should be. I would ask first, Mr. Gould, then Mr. Gray, to just comment on their perceptions of the need for closing or not closing the nonbank bank loophole and as it applies to the safety and solvency of the FSLICs.

Mr. Gould first.

Mr. GOULD. There is an argument with which we do not agree that if you don't close the nonbank bank loophole you are endangering the FSLICs. Now as best I can understand what I believe is rather tenuous logic here, is that all kinds of commercial firms will come in and establish nonbank banks in competition with S&Ls and the S&Ls won't be able to make it in that competition and therefore, they will decline and if the S&Ls decline obviously so does the FSLIC because the future assessments won't be available to the FSLIC.

I go back, at the risk of being redundant, that a nonbank bank has limited powers, far more limited than an S&L franchise so I am not sure it is—they are not equal. You don't just create de novo a nonbank bank and have the total equivalent of an S&L and an S&L franchise. Indeed, I think the other logic prevails the other

way, which is that if one were to ease the restrictions on unitary and multiple thrifts holding cost and one were to settle the ground rules here you might find more people willing to come in and buy S&Ls and add capital and add management.

So I do not think FSLIC is endangered. I don't think nonbank banks are going to put the S&L industry out of business even if you allowed a lot of them to be chartered and therefore if they don't put the S&Ls out of business, they are not going to endanger the FSLIC.

Mr. GRAY. Let me respond.

Mr. GOULD. Now for a different opinion.

Mr. GRAY. I don't think nonbank banks will put the S&L business out of business, no. I would like to see the nonbank bank loophole closed once and for all closed shut, and my druthers would be to see no grandfathering at although I don't think that is practically possible. Basically my experience is that when you can get a franchise right in a State or several States and this seems to be logical, also, for several thousand dollars, why would you want to come in and take a failed thrift and because there is uncertainty on this issue, there wasn't before when we were getting a good many more responses at our bidding conferences for failed thrifts, since that time, since the advent of the nonbank banks really in 1984, I believe, we have seen the kind of interest that we had before begin to dry up and so I don't take the position on the merits of having nonbank banks at all. It is simply a practical thing for me that it makes it more difficult to whatever degree to sell failing thrifts when you have an alternative that costs you very little, to nothing, to begin.

Mr. CARPER. Thank you.

The CHAIRMAN. Congressman Price.

Mr. PRICE. Thank you, Mr. Chairman.

Mr. Gould, in your statement you referred to improved supervision as an important element in your plan. You really don't elaborate on that. I wonder if you could do so briefly.

Mr. GOULD. Well, we have been very much in accord with Chairman Gray and the attempts that he has made in the last few years to improve the size of his supervisory staff and to improve their quality. Indeed the fact of moving many of those people out to the 12 Home Loan Bank Systems as the principal supervisory agents in each geographic area was also a step that we thought was well worthwhile.

So I think one of the things that has happened here as the Chairman suggested earlier is you want into rate deregulation and you went into a variety of expanded activity particularly at State-chartered levels and then at that point the Bank Board was not adequately staffed for the, indeed, more sophisticated supervision that had to take place.

The Bank Board has moved quite aggressively and Ed can quote the numbers better than I, but they are impressive as to the amount of increase taking place in the supervisory staff at the field level.

Mr. PRICE. Beyond that question of staffing levels do you have in mind a substitute for changes in regulation?

Mr. GOULD. Well, sir, we try to draw careful distinction between supervision and regulation. Regulation to us means setting the rules and supervision means making sure they are being followed. We have supported the supervision, increased supervision. We have not involved ourselves in the direct regulatory apparatus of the Home Loan Bank Board as an independent regulatory agency. We in the Treasury and executive branch try to walk a proper line between involvement in the regulatory process in terms of general policy support.

Mr. PRICE. So your recommendation here simply has references to staffing levels?

Mr. GOULD. Staffing level systems, everything that has to do with making sure the institutions in the field are being run by safe and sound standards. The standards, however, being set by the regulator, the Home Loan Bank Board.

Mr. GRAY. In other words what I heard was you are not trying to inject yourself into the policies or processes of an independent regulatory agency with respect to rules.

Mr. GOULD. That is correct. Nor am I at all certain that that is our role.

Mr. PRICE. If I could turn just a moment, Mr. Gray, to your testimony. You on page 2 refer to a study that you completed last year showing the thrift industry as a whole was paying at least $4 billion a year more than necessary precisely because of market concerns about troubled thrifts and negative perceptions of the FSLIC deriving from its weakened condition.

How do you arrive at such a figure? On what basis do you make that estimate?

Mr. GRAY. It was a very complex study that was actually undertaken by the Federal Home Loan Bank System. A number of the Federal Home Loan Bank presidents. It was headed by former Bank Board member Don Hovde. I cannot get into all of the details of it, particularly here, except that was the result of that study.

Mr. PRICE. That is the dollar figure you put on the lack of investor confidence and its impact?

Mr. GRAY. Yes—well, and this obviously applies to troubled thrifts and severely troubled thrifts. The public knows in one way or another that they are having problems and in addition the general perceptions of the FSLIC fund. I think both of those contribute strongly to this problem.

Mr. PRICE. OK.

Mr. GRAY. I have a note from staff that this was a statistical study as such. It compared FDIC statistics to the FSLIC for a 5-year period, and on that basis we found that the cost in 1985 was at least $4 billion more.

Mr. PRICE. That is using FDIC figures as a base point, for point of comparison?

Mr. GRAY. Well, both.

Mr. PRICE. Thank you, Mr. Chairman.

The CHAIRMAN. The committee will be in recess for 15 minutes, at which time we will return and call upon Mr. Wylie. We will go until 5 to 1, at which time we will break for lunch to 2 o'clock.

[Recess.]

The CHAIRMAN. The committee will come to order.

Will you shut that door back there, please.

Mr. Wylie.

Mr. WYLIE. Mr. Secretary Gould, my very expressive, articulate colleague from Iowa a little while ago referred to your plan as just one step removed from smoke and mirrors. I think the gentleman from Connecticut early yesterday talked about it as being maybe some smoke and mirrors, too. I would like to have your comment on that.

I thought it was a pretty good plan when I heard you testify about it last year and I co-sponsored the bill that would put it in place with the chairman at your request. I think you ought to have an opportunity to comment on it.

Mr. GOULD. Well, I appreciate, Mr. Wylie, a chance to do that because I worry that in some of these complicated proposals that are put forth people often look for sort of pejorative shorthand ways of characterizing them.

I think that is unfair to our plan.

The CHAIRMAN. Excuse me, Mr. Gould, I am glad to hear that but read your own testimony as to how you characterize some of the others.

Mr. GOULD. Absolutely, and I think justly so in their case.

If I may return to our plan.

The CHAIRMAN. Wowee, the man has been beatified.

Mr. GOULD. No, no, what Mr. Leach was getting at is the principle here that I think you should all consider, and we should be well aware of. The fact that money is borrowed is not the basis for calling it smoke and mirrors. Let me give you an example. If you are in Iowa and you want to build a highway and you do not have the money to build that highway nor do you want to sock the taxpayers with enough money up front to do that, what you do is you go out and you borrow the money to build the highway and do that by selling revenue bonds. A well-established pattern of municipal finance. It has been around a long, long time.

Then you pay those bonds off over time, either by appropriating money from the tax revenues each year or in many instances by constructing toll booths and paying the revenues from the toll booths to pay off the bonds.

The same certainly was true in my home State when I was the chairman of a number of State agencies having to do with housing, having to do with hospitals, having to do with college construction, and all those instances where it was considered to be in the public good to have institutions created or to have buildings created, schools, houses, and the money was not available at the front end.

The way municipal finance works is you go out and borrow it, and you pay it back over a stream of future revenues. That is what our plan is and I do not consider that to be smoke and mirrors. Indeed most of us on a personal basis often have to go on and establish lines of credit for things we want and we pay it off over time. Paying off over time to me is not inherently smoke and mirrors.

Mr. WYLIE. Thank you. I knew you would have an answer and I think your analogy is appropriate.

Mr. Gray, Chairman Gray, this question has been commented on before but I do have a specific question, and it is rather lengthy but before I finish you will see where I am coming from.

Yesterday the question of FSLIC exit fees was raised a number of times. Mr. Sullivan testifying on behalf of the National Council stated that the Council supports imposition of a reasonable exit fee and suggested a formula of 2 plus 2, that is an exit fee equal to 2 years regular deposit insurance premiums plus 2 years of special assessments.

On page 15 of your testimony you also call for statutory language to reaffirm and expand the authority of the FSLIC to impose fair and reasonable exit fees.

At yesterday's hearing, I believe it was my friend Mr. Neal from North Carolina who mentioned that in a conversation with you, you stated that an exit fee equal to 10 years of assessments would be appropriate and in fact I understand that such fees have been imposed.

While I recognize that consideration may have to be given to opposing some bar from withdrawing from FSLIC to protect the deposit base to the success of recapitalization proposal, do you feel 10 years is reasonable. You alluded to the recent Supreme Court case in your testimony today. In that case the Federal judge characterized the 10-year exit fee imposed on Eagle Savings & Loan which was acquired by a Merit Trust from my State as extortion. The judge further questioned the Bank Board's authority for imposing such an exit fee.

Just what in your opinion is reasonable? Is it 10 years or 2 plus 2 as suggested by the National Council or does it lie somewhere inbetween, and exactly what is your authority under current statute for imposing exit fees. You now have the authority to impose a 10-year exit fee; that would be pretty expansive. I wonder if you need additional authority?

Mr. GRAY. Well, let me start by saying that in my conversation with Congressman Neal I pointed out that we were envisioning, hopefully, a kind of recap plan like the one that the Bank Board and the Treasury has proposed. We are hoping that it would be adopted. In order to make sure that the long-term obligation can be paid for the debt that has been incurred, we have to have some means by which this can be done, and that basically in our plan is through the maintenance of an adequate premium stream to do it.

In several cases we have said if the acquired thrift institution were to remain in the FSLIC and pay pursuant to the terms of our recapitalization plan, or 10 years, and we determined what that figure is on a present value basis, then that we felt would be at least under the current circumstances appropriate. In fact as we have gone through the numbers, by coincidence it works out to be what we believe would be in fact needed to make sure that the recap plan would be viable. In other words, about 10 years or between 1.25 and 1.5 percent of deposits of the institution which would exit would constitute a means by which we could in fact maintain the viability of this Treasury/Bank Board recap plan.

The numbers, the arithmetic works out that way.

So in that case I think something in that area would be appropriate. Short of that, I am not sure that investors in the bonds that

we are talking about would be interested in acquiring those bonds unless they can be absolutely assured that there is going to be a sufficient stream to be able to deal with the repayment of our debt obligations.

Mr. WYLIE. My time has expired.

The CHAIRMAN. Mr. Barnard.

Mr. BARNARD. Excuse me, Mr. Chairman, I wasn't ready.

The CHAIRMAN. Oh, you are always ready.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Gray, there have been some questions that individual home loan banks have been overly rigorous and arbitrary in their supervisory actions, including the closing of certain savings and loans. For example, in Texas, people are especially concerned over situations like Vernon Savings and Loan and Independent American Savings and Loan.

I have two questions. First what does the Bank Board do to monitor these situations?

Mr. GRAY. All right, that is the first one. I don't normally talk about individual institutions and I am not sure you want me to. Do you want me to talk to——

Mr. BARNARD. It has been in the press.

Mr. GRAY. Well, in both cases we are talking about severe difficulties and insolvency and it is severe. In the hundreds of millions of dollars.

We exercise continuing close oversight over those kinds of institutions and in some cases of course those kinds of institutions are placed in management consignment programs of varying types. I believe that in one case for more than a year now there has been a State of Supervisory agent in effect managing the day-to-day operations of the institution. In the other case a board of directors was put in place to govern the operations of the other institution.

Mr. BARNARD. But do they actually report to the Federal Home Loan Bank Board in Washington? What kind of monitoring do you do over these decisions——

Mr. GRAY. Those are supervisory actions out of the supervisory staff of the Federal Home Loan Bank of Dallas.

Mr. BARNARD. Does the Washington office have any oversight over those at all?

Mr. GRAY. Yes, it certainly does.

Mr. BARNARD. Do you concur with the decisions that are made in the individual home loan banks?

Mr. GRAY. If the issues are brought to the board itself, but we have the Office of Regulatory Policy and Oversight in Washington working very closely with the supervisory operation at the Dallas bank.

Mr. BARNARD. I don't know whether I got the answer I want or not, but——

Mr. GRAY. I would be happy to try to answer more if I could.

Mr. BARNARD. I was wondering if you could later provide something for the record of these kinds of cases, and how that oversight takes place.

Mr. GRAY. All right.

[The information from Mr. Gray regarding referred to cases and how oversight takes place can be found in the appendix.]

Mr. GRAY. In many cases I would say that we institute supervisory agreements to assure that speculative and risky operations are not permitted.

Mr. BARNARD. Do you know of any cases whereby the Washington office has differed from the regional office in a closing of an institution?

Mr. GRAY. The FSLIC would close an institution.

Mr. BARNARD. In other words, are there any instances where the Washington office would take a different position or the FSLIC would take a different position than the regional home loan bank?

Mr. GRAY. I could conceive of that but I think generally there is a good deal of consultation.

Mr. BARNARD. I think that we need to probably go into that further, but I will do it individually as to how forbearance would work if we don't have some monitoring of the decisions of the regional banks.

Mr. GRAY. Well, we do monitor. The Office of Regulatory Policy, Oversight and Supervision does monitor very carefully specifically for the Bank Board what supervision is doing in any of the bank districts.

Mr. BARNARD. Mr. Gray, I understand that my colleague, Mr. Vento, is considering an amendment to H.R. 27 that would impose some kind of a direct investment rule. As you know, you know my position on that and I made it plain yesterday that I would like the Home Loan Bank Board to finish its hearings and its study and that we should deal with the direct investments outside of the H.R. 27 legislation.

Mr. Gray especially, would you believe it premature for Congress to legislate such a rule in H.R. 27 before the hearings of the Home Loan Bank Board have been held?

Mr. GRAY. Well, the hearings will be held very shortly. The decision of the Bank Board to be made will come later.

Mr. BARNARD. But I am hoping this bill will be passed a long time before then.

Mr. GRAY. Well, let me be very frank and candid with you. I would like to see the regulatory flexibility of the Federal Home Loan Bank Board in dealing with this issue maintained. I believe that placing things in statute takes away from that flexibility. However, if the Bank Board were to fail to extend that regulation which I feel is already too weak in any event——

Mr. BARNARD. That is not my question, Mr. Gray. My question is we are expecting to bring this bill to the floor of the House and I am sure the Chairman concurs in that, within the next few days, as soon as we can have general, a meeting next week and have the markup. That means it is going to be on the floor of the House very shortly.

The question I am saying is, would you agree that we should wait and not involve direct investment rules with this legislation until the Home Loan Board acts?

The CHAIRMAN. Let me interrupt to get the time certain here. The markup I think in full committee occurs on February 10. That being the case, I don't anticipate that we would be on the floor until sometime after the recess.

Mr. BARNARD. Still that will be long before——

The CHAIRMAN. Which would be approximately February 18th or the following week. I don't want the press to write any stories that we will be on the floor 7 days from now. We really don't know when we will be on the floor, but it will be subsequent to our returning from the Washington/Lincoln Day recess. I don't know when the board meets again.

Mr. BARNARD. I am sure that will be before the Home Loan Bank Board reaches a decision on this bill. You and I both know what Mr. Proxmire in the Senate, he offered a closing of the nonbank bank loophole but he also put a direct investment rule in it. Now, I just don't—I want to know how do you as chairman of the Home Loan Bank Board feel about us acting before the Home Loan Bank acts?

Mr. GRAY. I have to come back again and say that in my humble opinion if there is any chance that we will not continue that regulatory process, any chance, then I think it should be included in statute. I think Congressman, it is absolutely necessary, it serves as a symbol of the resolve and commitment of the Federal Home Loan Bank Board to do its part to make recapitalization worth doing, not only the direct investment regulation but the others.

Mr. BARNARD. Mr. Chairman, if the three-member board of the Home Loan Bank cannot at this point without the hearings and discussions reach a decision, how do you expect a 52-man committee without any hearings to fairly address this subject of direct investment? So the question I am asking you, and I guess I am not going to get the answer, is do you favor us including an amendment in this bill, H.R. 27, to address direct investments? That is the H.R. 27 bill.

Mr. GRAY. Yes, I would. Let me tell you what I would do. I would say that an attempt should be included which would go out of existence at such time as the Federal Home Loan Bank Board adopted such a regulation.

Mr. BARNARD. In other words, what you cannot do you want Congress to do?

Mr. GRAY. I——

Mr. BARNARD. In other words, if the regulatory authorities are not capable of regulating in the area of the savings and loans, you want us to put it into the law?

Mr. GRAY. That is right.

Mr. BARNARD. Well, I will tell you what, if it was—if it comes up it is going to defeat this bill. I guarantee you that.

Mr. GRAY. Then if we don't even have the will or resolve to deal with simple things like this, I cannot put my——

Mr. BARNARD. It is not simple.

Mr. GRAY. You cannot put the recapitalization bill in.

Mr. BARNARD. It is not simple if the Board cannot reach a decision.

The CHAIRMAN. The time of the gentleman has expired.

Mr. Gould.

Mr. GOULD. Yes, sir.

The CHAIRMAN. Let's simplify this thing. The Home Loan Bank Board voted. We are going into a time capsule, we are projecting ourselves into the future, and 2 new members of the Board said nix on direct investment rules. So the Congress, we the Congress, are

now having hearings, and my question to Secretary Gould is where does Treasury stand on the direct investment regulation that now is in existence and is up for essential——

Mr. GOULD. All right, sir.

I think we have to give you a partially hedged answer on the basis that we, too, would like to benefit from whatever the public hearings produce. We would like to see how the industry looks at this and we would also like to see what the deliberations are of academics, and their arguments on——

The CHAIRMAN. Secretary Gould, are you telling me that a man as brilliant as yourself doesn't know the industry has already taken a position on this? They are not in total agreement. They never will be. Let me ask that 25-year experience Wall Street—I am trying to think of a wonderful word to describe it—avatar.

Mr. GOULD. Sir?

The CHAIRMAN. Avatar of Wall Street for 25 years, let me ask you, Secretary Gould, to take off this hat as Secretary and just be a man of much experience. Now you are testifying of and on your own on the direct investment rule. You have looked into this and you have heard Chairman Gray's arguments in this area. You have looked at the situation in the S&L industry. What is your opinion on the direct investment rule?

Mr. GOULD. All right, sir, I think those are worthwhile ground rules. One of the things I have learned from 25 years of experience in Wall Street is to try to learn as much about a subject before I do, before I have to make an important decision. So I would go back to saying that I would like to have the benefit of the public hearings, and I would like to have the benefit of the deliberations of the Board, and it is not a subject that I have followed that closely in the past.

Having said all of that on a personal basis, Mr. Chairman, I would say that I think there is an, as best I understand the issues, there is room for some regulatory discretion on the following basis and that is if you grant people a series of powers broadly as a regulation passed by the Board applies broadly to the industry, maybe it is modified by the amount of capital an institution has but basically it is a broad regulation, some people handle those powers better than others, and that is where I think some regulatory discretion comes into the picture, that there ought to be a point at which someone says you have been doing a good job, I will let you go a little further; or you haven't been doing a good job, I think we ought to have a hiatus.

But as to what that level is, or how much capital and so forth, we don't know. It hasn't been something that we have been involved in to the degree at the Board and I am sincerely anxious to see what arguments are brought forth at those public hearings.

The CHAIRMAN. Thank you.

Mr. GRAY. Let me just add that the hearing comes up next week.

The CHAIRMAN. How am I on time?

Secretary Gould, essentially the insurance on FSLIC and FDIC is about the same over the years when you consider the rebate.

Mr. GOULD. The rate, sir?

The CHAIRMAN. The rate, the insurance——

Mr. GOULD. The regular premium of both is 1/12.

The CHAIRMAN. That is what it is boiled down to, however, the premium has gone up on commercials in the recent year or two because the rebate has not been there. They have eliminated the rebate. So it has gone up to ⅛, has it not? No?

Mr. GRAY. No.

The CHAIRMAN. No.

Mr. GOULD. The FDIC or——

The CHAIRMAN. I am talking about FDIC.

Mr. GOULD. Not to my knowledge.

The CHAIRMAN. It is at ⅛. I thought I heard a couple of our bankers complaining they were not getting the rebate.

Mr. GOULD. My understanding——

The CHAIRMAN. OK

Mr. GOULD. Is that the FDIC until the last couple years has run at a profit.

The CHAIRMAN. What has the rate been?

Mr. GOULD. One/twelfth.

The CHAIRMAN. And beyond the 1/12 they had a rebate? Your staff is saying yes, behind you.

Mr. GOULD. Let me try to answer. To the extent that the FDIC runs each year at a profit, there is a rebate to the industry.

The CHAIRMAN. Absolutely.

Mr. GOULD. That has not occurred in the last two years. So the effective amount has gone up because there has been no rebate, but still it is only 1/12 in total.

The CHAIRMAN. So it has gone up to 1/12. It was less than that. As you know the FSLIC rate is 1/12.

Mr. GOULD. Yes, sir.

The CHAIRMAN. That is set by statute.

Mr. GOULD. Right.

The CHAIRMAN. Now, when did the Treasury recommend to this committee or to the Senate Banking Committee that we increase the rate, the FSLIC insurance premium?

Mr. GOULD. You say did we?

The CHAIRMAN. When did you?

Mr. GOULD. I am not sure we ever did. I believe that the Bank Board put on a special ⅛, I do not believe the Treasury was involved in that in any way.

The CHAIRMAN. You see I am looking at your testimony, you stated that they had not been—this insurance premium was too low, correct?

Mr. GOULD. Too low historically.

The CHAIRMAN. Yes. And I am wondering how come Treasury can say that now because of what happened when interest rates started to jump way up.

Mr. GOULD. Yes.

The CHAIRMAN. Back in the late 1970s.

Mr. GOULD. That is a retrospective judgment, yes.

The CHAIRMAN. Correct. In that interim period, I am wondering how in view of your testimony today, how come we haven't received any request from Treasury to increase that premium?

Mr. GOULD. Well, I suppose there are a number of answers. One, the special premium did go on in 1985 at the discretion of the Bank Board and I believe that is when the Bank Board, the independent

regulator who oversees such things, felt that the problem was becoming of a nature that requirod that. Prior to the last few years most of the perception of the problems in the early 1980s, for example, were that of interest rate differentials and that the major problem of the S&Ls would be cured if interest rates went down. Therefore, did not call for a special assessment.

Indeed the interest rates did go down, they went down even more substantially than people might have thought, and the special assessment was not needed for that. However, what began to be seen as the 1980s proceeded was that there were quality problems out there that required more money than had been perceived before. I think when that perception became sustainable, the additional special assessment was imposed.

The CHAIRMAN. Thank you.

Now I call on—looking at the time of arrivals—Mr. Saxton.

Mr. SAXTON. Thank you, Mr. Chairman.

I just would like to revisit so that as you said, Mr. Gould, you like to know what it is that you are making decisions on and so do we.

Mr. GOULD. All right, sir.

Mr. SAXTON. As much information as we can get is certainly helpful. So I want to revisit what our vice-chairman, Mr. Wylie, had brought up shortly after we returned with regard to the financing mechanism which is certainly considered by me at least to being the key to making this entire program operable.

My understanding of that is—and I am going to recite for just a moment what my understanding is so that you can correct any of it if it is incorrect—that you would form a new financing corporation which would receive funding up to $3 billion from various Home Loan Board banks from the 12 districts across the country.

Mr. GOULD. Yes.

Mr. SAXTON. And that money would be used, $2.2 billion of it, to issue long-term bonds which, on which the interest would not be due and payable until——

Mr. GOULD. No, sir, that is indeed the aspect of the U.S. League's plan.

What we do with the $3 billion which is taken down gradually over several years because the Home Loan banks don't have an earnings surplus of $3 billion at the moment, but we take it as it is coming in over several years. We then of the $3 billion, take $2.2 billion and buy, not sell, buy, all probability U.S. Government zero-coupon bonds, of which there is a well-established market out there, and we say those bonds at maturity will pay the principal of the bonds that we will issue to the public to raise the money.

So what we have done with the $2.2 of the $3 billion is to guarantee the repayment of bonds that the financing entity then sells, regular bonds with coupons that pay interest yearly.

The interest on those bonds we sell will be paid under our assumptions by in essence the diversion of part of the assessment and premium fees of FSLIC, only to the extent necessary to pay the interest.

So if you buy one of our bonds you have from day 1 a government piece of paper backing it that says at maturity you will get all of your principal back.

Mr. SAXTON. Excuse me but you are getting ahead of me.
Mr. GOULD. But we are not selling zeros, we are buying them.
Mr. SAXTON. I appreciate that and I am not questioning what you are proposing to do. I am only trying to understand it.
Mr. GOULD. Sorry, go ahead, sir.
Mr. SAXTON. You are going to in effect lend $2.2 billion over a period of time.
Mr. GOULD. No, sir. We don't lend it, sir, we use it to back up the principal value of the bonds we sell.
Mr. SAXTON. I am having a hard time understanding what it is you are going to do with the $2.2 billion.
Mr. GOULD. Are you familiar with the—this is relatively new. It all has to do with the magic of compound interest.
Mr. SAXTON. I have no problem with——
Mr. GOULD. $2.2 billion after 30 years compounding at roughly today's interest rates will produce $15 billion, so we invest the $2.2 billion and invest in government bonds which at maturity will be equal to $15 billion. That is the same $15 billion that we borrow in the public market and we use it to back up these bonds so they really have a good credit. So we invest that, sir, not lend it.
Mr. SAXTON. You got me to that step, I understand that, and that will pay the principal on the bonds at the end of a 30-year period roughly.
Mr. GOULD. Yes.
Mr. SAXTON. The only question left to be answered is how we pay the interest.
Mr. GOULD. The interest is repaid—the interest is paid every year by a portion of the regular assessment, 1/12 of 1 percent a year leveled by FSLIC on the industry. A portion of the special assessment which is five-phased down to zero in our plan over 5 years; and that is an adequate stream of future earnings to pay the interest on these bonds.
Now, there are always in these things certain assumptions, assumptions as to the deposit growth in the industry, there are assumptions as to reinvestment rates, so a set of assumptions outlined in some computer runs, that is adequate money to pay the interest over the year and in the earlier years to produce money left over after you pay the interest.
Mr. GRAY. Let me add there will also be a certain amount coming from FSLIC investment income and also from the realization of the disposition of assets. So in toto——
Mr. GOULD. But that remains in the FSLIC, not in the financing mechanism.
Mr. GRAY. Right.
Mr. SAXTON. So we might say the toll booth that you referred to in Mr. Wylie's question is in this case the 1/12 percent.
Mr. GOULD. Yes, but also a portion of the 1/8 which is now in full effect and which under our plan phases out of existence over the next 5 years.
Mr. SAXTON. Did you leave yourself latitude to raise the total up to the 1/8?
Mr. GOULD. Yes, sir, we did. We said this is—this is really because of the industry concern about this amount of special assessment we have said the special assessment phases down but if it is

necessary to reimpose it in order to bolster what is available to pay the interest or other emergencies, the Bank Board at its discretion can reenforce it.

Mr. GRAY. We have another cushion, that is $800 million in the surplus of the reserves of the banks which could also be used if necessary.

Mr. SAXTON. I thank you very much.

The CHAIRMAN. Mr. Kennedy.

Mr. KENNEDY. Thank you, sir.

Just following up on that question——

The CHAIRMAN. Let's make sure your microphone is turned on.

Mr. KENNEDY. I am sorry. Thank you.

In following up on that line of questioning, it just seems that—I don't question your ability to sell $2.2 billion, to provide $2.2 billion which is going to gain you $15 billion, but it seems to me that that is just a closed loop. What you said earlier as I understand it was that FSLIC currently cannot make it using 1/12 of 1 percent of its institutions' total deposits in order to make payments, which is why it is in deficit.

So, therefore, if you draw down the $15 billion to pay off the banks that are in trouble, then how do you—goes back to the Chairman's earlier question—how will you attract anybody to buy these bonds?

Mr. GOULD. Well, let me try it if I may from a different point of view and perhaps, and I would be very happy to do this, I know this is somewhat new to you, compared to people who have been working on this since last year.

Mr. KENNEDY. It is probably a silly question, sorry.

Mr. GOULD. No, I appreciate questions that are confusing people's minds. I would be happy to furnish you our computer runs because it is a little easier to do working from hard copy. But the premise that really underlies all of this is there is an existing problem of FSLIC which is greater than any reasonable amount of assessment could handle when necessary. So you have to go borrow money to take care of the problems of the past.

Now, how do we borrow money that really gives people a strong sense that they are going to get it back and doesn't involve the Federal Government? Well, we nicely have over here a bank system that will contribute $3 billion of their earned surplus and we invest $2.2 billion of that into bonds which will mature compounding with interest over 30 years, will be the $15 billion we borrow. So we say to people, your principal, if you buy our bonds we guarantee you based on these underlying U.S. Government zero coupons that you will get your principal back.

So you say, fine, but what about my interest? We say, the way this program is designed there will be plenty of room to pay the interest on those bonds out of the regular assessments on the industry as they have been in the past.

Mr. KENNEDY. But you get two people that have their hands on the $15 billion, right? You get the $15 billion you will be using——

Mr. GOULD. The $15 billion you borrow from the public is paid back by investing $2.2. Monies advanced to FSLIC, FSLIC never has to pay the financing company money back.

Mr. Kennedy. The $15 billion will be used to bail out the banks, isn't that correct?

Mr. Gould. It will be used to resolve them.

Mr. Kennedy. Sorry, whatever word you want to use. So you will use the $15 billion to resolve the banks' problems, then how are you going to also assure that the person that is willing to put up the cash, that he too will be paid back?

Mr. Gould. By investment of the $2.2 billion contribution of the Home Loan Bank System compounded over 30 years.

Mr. Gray. Congressman, what happens is that leveraged $2.2 billion in effect goes into a trust fund and that remains untouched during the life of the bond and at the end you have $15 billion because of the compounding effect of the zero coupon bond. So that pays, that redeems the bonds after the 30-year period.

Mr. Gould. It is very much like our Savings Bond Program.

Mr. Kennedy. The only one thing I don't understand, and then I will yield or my 5 minutes will be up. The point is you got two people getting their fingers into the $15 billion. You have the banks in it and you have to still pay back the $15 billion.

Mr. Gould. $2.2 billion is a contribution. They give it to us. We are able to invest it because somebody has given us money to invest and we don't have to pay back which is what the Home Loan Bank Board System is in essence doing. That takes care of the bondholders, all right? It pays off the principal.

So that enables you to take the money you borrowed and you are saying this investment will pay the bondholders off in 30 years, therefore the money I borrowed I can use to resolve the banks.

I would be delighted—it is easier if I can show you hard copy. It is hard to explain and I would be delighted to do that personally, sir.

The Chairman. The time of the gentleman has expired. As the Chair stated earlier, we have gone beyond the time that we originally stated, but we are going to have a luncheon break so we cannot overtax the stamina of our two delightful witnesses, and we will come back rather than 2 o'clock since we have gone over, we will come back at 2:15. We stand in recess until 2:15.

[Whereupon, at 1 p.m., the committee was recessed, to reconvene at 2:15 p.m., the same day.]

AFTERNOON SESSION

The Chairman. The committee will come to order.

The Chair would observe hopefully everybody in the audience has brought their sleeping bags and what is it they eat, that dried beef.

Mr. Gonzalez. Beef jerky and things like that. I have some in the office.

The Chairman. The committee will come to order.

The Chair recognizes Chairman Gonzalez.

Mr. Gonzalez. Thank you, Mr. Chairman, and I also want to thank the two very distinguished witnesses that have taken their time and have cooperated. I want to compliment you particularly for very effective hearings in a very, very expeditious and timely way, because as you and I know, everyone else knows we are having a crisis out there. I did have some specific questions from I could say my special viewpoint on housing and I wrote

out a specific question, I am going to stick to it, that I would direct to Mr. Gray.

Yesterday, we heard from the industry most directly involved, who have worked I am sure very hard to try to figure out the best way to resolve a dilemma. But, if we recapitalize the FSLIC, and if your regulatory actions keep the industry from disaster, would housing finance be any better off since it is—and also are clearly movement away from housing finance as their main reason for existence, would homebuyers be any better off if the industry returns to health or should Congress be thinking in terms of going whole hog and homogenizing banks with S&Ls because it seems to me, and this is just a little side barrack, as things now stand, maybe such a merger would not make much difference insofar as housing loans and financing are concerned. So actually, that breaks down into an about two-three different questions, the first if you do succeed, what if any will be the benefit to the housing finance framework reference of things.

Then, since S&Ls are clearly moving away from housing finance, after all they were created for this purpose, no nation in the world that has set forth on a national commitment to provide housing for all its citizens, has ever failed to set up the financial mechanism or the framework of financial reference, and this country did beautifully, their leader of our Nation at that time were great leaders and S&Ls were founded for that very specific purpose they were given to the complaint of the banks special privileges, but only because they were going to be the financial reason for the building at affordable prices and the availability of those houses to the American family at affordable rate, and I know that so many things have happened that have impacted especially on us internally, that perhaps it was inevitable but seems to me that this from our standpoint is a big issue, otherwise, then what we are doing here is just providing money so that we can enable the S&Ls to survive in a homogenized financial institutional struggle, and it would be tough in my opinion. So I got that off my chest.

Mr. GRAY. Congressman Gonzalez, as I have indicated in my written statement, in my opinion going back through the longstanding body of law, the principal purpose of the savings institutions system is primarily to support housing finance and home ownership opportunities for Americans, and indeed many of our healthiest institutions are doing just that, in fact, many of our most profitable institutions have basically stuck to their knitting and they are achieving great profitability because they are engaging in the kind of business that they know best.

Let me say that at the end of 1986, savings institutions in this country held in their portfolios more than half of the residential mortgage debt outstanding in this country for nearly three quarters of a trillion dollars. Thirty percent of the Nation's mortgage-backed securities were not held by private investors or insurance companies, or pension funds, but by thrifts. That is to the tune of $156 billion at the end of 1986. During that 1986, savings and loans originated half of the home mortgages in the country compared to only 19 percent by commercial banks. It is my belief that the recapitalization of FSLIC will have a very salutatory effect in that by restoring confidence the cost of money to operate for these institu-

tions, will be lessened. As a result I think that that may well reflect on rates for mortgages and in addition to that, the confidence that people will have to a greater extent in our system will in overall sense benefit us greatly in that regard.

But I think were a merger to occur, there would be very definite pressures to move away from the primary thrust all of these areas, it is the intent of Congress that savings institutions, primarily do this, as justification for a separate system. So I think in the whole maintaining a separate system that is healthy, that has the regulatory discipline to keep it healthy, that has the public perception of a strong system, is certainly in the best interests of home ownership opportunities in this country.

Mr. GONZALEZ. I thank you very much, Mr. Chairman. My time has expired and I will just wait so that I don't deprive somebody else, but I do have three questions that have been requested that I propound to Mr. Gray, mostly emanating from the industry in Texas and so I will defer.

The CHAIRMAN. Mr. Bartlett.

Mr. BARTLETT. Thank you, Mr. Chairman.

Mr. Gray, Chairman Gray and Secretary Gould, you presented very good testimony for us today and clearly a well-thought out plan. I want to ask you about an element I don't believe is in the plan at this point, but I get your sense as to whether it ought to be included. That is, in the area of amortization of loan losses as opposed to the immediate realization of loan losses.

Chairman Gray, you said eloquently on page 2, you have said it elsewhere, that the Bank Board is exercising appropriate forbearance, as you can, and so, in that context I want to inquire as to are there, it seems to me there are some opportunities to give you some additional tools for forbearance when you are willing and eager to provide forbearance, but in fact you don't have the regulatory tools.

Would the tools you think that it would be in order to provide a regulatory tool to provide for an amortization of loan losses similar to FASB 15 by FDIC to amortize over a multi-year period of time those losses that are recognized in the current year, to give you the tools for forbearance as opposed to simply the willingness?

Mr. GRAY. Well, the use of FASB 15 is available to any savings institution in this country already to restructure its loans in any event.

Mr. BARTLETT. For commercial real estate loans?

Mr. GRAY. Yes, it is already available to institutions. Obviously, FASB 15 doesn't operate as a restructuring device if the loan is not going to be collectable. But, that is already available and is being used.

Mr. BARTLETT. Chairman Gray, when an institution under the classification of assets regulator has a loan loss or a loan that is declared to be substandard or otherwise classified, does that institution then, that loss go against the net worth in that area, or is it amortized over a multi-year period of time?

Mr. GRAY. Under FASB 15 it is my understanding that there is not a write-down involved.

Mr. BARTLETT. How about under today's current practices?

Mr. GRAY. Under today's current practices there is not a write-down involved unless a determination is made that the loan is not going to be collectable. And in the whole scheme of classification of assets which we adopted in order to try to make progress to bring ours closer to commercial banking practices, I think in large part our practices are very similar to theirs. I can get more specific on this in this hearing if you wish, or I can talk to you at later time about some of the specific aspects of classification, but, we the staff had a meeting yesterday with the staff of the FDIC, and while there are some slight differences the thrust of the difference is very minimal. Let me say this. In the case of the commercial banking regulators, if an institution becomes insolvent, that institution is immediately put out of business. We have many institutions in our industry that are operating with substantial amounts of negative net worth. I think that frankly we are providing an incredible amount of forbearance in our practices, we are looking carefully at the quality of management of these institutions, we want to see them, it is in our interest to see them have the chance to turn around and in the case where that is true, we continue to exercise forbearance.

It is those cases where you have a terminally ill institution that frankly got into its problems and had its difficult problems before the price of oil went down. The price of oil in some of these depressed economies has merely exacerbated what was already for all practical purposes a terminal case. That is what we really are talking about here.

Mr. BARTLETT. In many areas, there has been a dramatic reduction of collateral value that is different from institutions, specific of institutions, that were also very aggressive with all institutions in areas where real estate prices have declined by 40 or 50 or 100 percent. Then, all institutions then have, if not negative net worth, close to negative net worth, if their new appraisals were recognized immediately.

Are there opportunities in this legislation to give you additional tools to amortize those losses? If not, provide for us instances in which compilation in the way in which loan losses recognized today have been amortized over or been allowed to be amortized over a multi-year period.

Mr. GRAY. You mean through FASB-15?

Mr. BARTLETT. Whatever the mechanism that you employed. I hadn't heard of institutions that have been given that opportunity. But I would like to work with you to find out.

Mr. GRAY. Absolutely.

Mr. BARTLETT. Further, to work with you on this legislation to make certain that the legislation which is desperately needed is used to provide for a way to work out of the problem and not to precipitate any immediate problems.

Mr. GRAY. The difficulty here is we have to be very careful that when you can't work out of the problem, when there is no real way to work out of a problem, that there is no redemptions in the end, even if oil prices were to go back to $40 a barrel, particularly given the substantial operating losses that some of these institutions are inccurring on a daily basis.

Then you have to say at what point does forbearance serve any purpose whatsoever if there is no way in the end that this institution can possibly, even with good management, even with observance and of sound operating practices, cannot come out of? Then what do you do?

Mr. BARTLETT. My time has expired, but either a second round or later time I might want to pursue this with you.

My question wasn't related to oil prices. It is related to real estate values.

Mr. GRAY. I understand. But one of the reasons for that is the drop in oil prices in the Southwest. Maybe not the only reason——

The CHAIRMAN. Secretary Gould, drawing upon your expertise, when you consider the large borrowing you would be looking for under this legislation, if you would share with us your thoughts on the necessity or non-necessity of an exit fee as far as the marketability of the offering is concerned.

Mr. GOULD. Well, I consider it to be an add-on. I consider it to be another piece of reassurance. But, in light of the fact that the special assessment which is phased down can be reimposed at the discretion of the Bank Board, I would see that, if you will, as the first line of defense against not having adequate flow of funds to cover the interest payments.

I think the exit fee, to me, almost becomes a matter of equity or fairness, and as I said earlier, that comes from the perspective that perhaps there was undercharge here in the past and people have prospered because of their franchise. I look at it as really a matter of equity that before people sort of abandoned ship and went the way understandably of their own self-interests, they should pay an exit fee. It does help the plan because of the contribution of money.

The CHAIRMAN. There naturally is going to be a controversy over what form the exit fee should take. Under the circumstances, Treasury has not expressed itself in this area.

I would appreciate a memorandum or statement or position paper from Treasury on the type of exit fee that they feel would be fair and equitable.

Mr. GOULD. We would be very happy to do that, Mr. Chairman. In fact, we have been working with the Bank Board actively in the past week. If I recall, there is a cushion built into our plan, so you can survive some deterioration of membership in this industry without impinging upon our plan. Beyond that, we have worked on levels of exit fee which would be of the category of sort of hold harmless people; people could leave and you wouldn't care.

At the same time, we don't want the fee to be fungible, equivalent of forbidding somebody to leave. We would be very happy to share our work, and the Bank Board, with you.

[The Treasurys' statement on exit fees can be found in the appendix.]

The CHAIRMAN. Thank you.

Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

I would like to follow up on that. I asked Chairman Gray earlier this morning about the exit fee, and specifically referred to the Florida case, the Barnett case, which you referred to in your testimony; and to ask, if I may, your authority to impose the exit fee.

The judge in that case questioned whether the Board had the authority to impose a 10-year exit fee, which is what you did there. Whether you think he is right—or I am sure you are going to appeal the case—or whether your statutory authority is limited to a fee equal to 2 years, as he put it, plus two regular deposit insurance premiums.

Could you comment on that and tell me what exactly you think the Federal Home Loan Bank Board authority is on that? And I think it is pertinent, to the question of Chairman St Germain as to what kind of exit fee should be imposed, whether you have the present statutory authority. I am asking whatever exit fee you think is necessary, is as good a way to put it as I know how.

Mr. GRAY. Well, on the basis of our studies to try to keep this plan that we have proposed viable, we believe that the two-plus-two is insufficient. You are talking about two regular premiums and two special assessment premiums is insufficient to maintain the viability of it, particularly if this were to become more of a problem over time. And, of course, we have a long-term recapitalization program.

I am not sure we know everything today that could or might happen out into the future, but we have to take into account if we are going to be able to obligate to this long-term plan, what could happen, especially if we want our bonds to be marketable, because they will be looking at that very carefully.

I was given a note here by the general counsel which I am not sure I can read. He probably couldn't read my writing, either. But it says we believe the Board has clear authority to charge an exit fee equal to twice the most recent annual premium, including special assessment. Our authority to charge more than that is problematical, and it probably doesn't make too much sense to say more about that because we are in litigation on that issue. As you know, that is the Barnett Bank case.

But, we obviously, as I am suggesting, would like the Congress to give us the authority that we believe we need to charge an exit fee again sufficient to preserve the viability of the recapitalization plan. That is all we are talking about.

If the Congress came to us tomorrow and said we are going to give you $25 billion—not that I am in favor of that—if the Congress were to provide an appropriation to recapitalize the fund, then this wouldn't be at issue at all.

Mr. WYLIE. You have answered my question.

You think you do have the authority to impose a fee equal to 2 years the insurance premiums, plus 2 years regular deposit. And you have said that you think it is problematical whether you have the authority to impose the 10-year exit fee, which is the issue in the Barnett case.

The Chairman has asked Mr. Gould to suggest what he thinks is an appropriate exit fee for purposes of this legislation.

Secretary Gould, on page 8, you urge Congress and the regulators to accommodate now acquirers of insolvent thrifts, and I think you accurately note that such action would reduce FSLIC's cost while, at the same time, bringing in important new sources of capital.

Does Congress really need to act on this? Doesn't the Bank Board already have the authority to sell a troubled thrift to virtually anyone it wants to?

Mr. GOULD. It is my understanding that the Bank Board has rather broad discretion in determining who can be the buyer of a thrift. My personal observation, which is true of the Bank Board and true of the Federal Reserve and otherwise, is very often independent regulators look to a sense of Congress as to perhaps how broad a definition of that should be. So that my impression is that, yes, the discretion is quite wide; but that we would appreciate some feeling from Congress to the extent that Congress felt was feasible.

Mr. WYLIE. So you think we probably ought to extend Garn-St Germain and get on that and pass your regulators bill to help in this regard?

Mr. GOULD. Yes, sir. I said in my testimony we support the regulators bill. But I think it is probably when it comes to the specific of how subsequent State action has preempted the need for Federal action, I can't speak to that personally, but the regulators certainly are able to do so.

Mr. WYLIE. Garn-St Germain, I think, applies in the case of failed thrift institutions. I think their present authority extends even beyond that whether we find a troubled institution situation. And you agree with that.

My time has expired again. Thank you very much.

Mr. GRAY. Yes, I agree with that.

Mr. WORTLEY. Thank you, Mr. Chairman.

Chairman Gray, I support the recapitalization of FSLIC. But let me ask you, what is the fallback plan in the event this does not pass the Congress?

Mr. GRAY. Let me—I don't know whether I can answer that in certainly a way that I would like. If we do not recapitalize the FSLIC and things get worse, and in not very long a period of time much worse—so if you are talking about a fallback plan, in our case we have been in that the only fallback plan available since we don't have the money, we can't even resolve cases. We are now in the fallback plan.

Mr. WORTLEY. Mr. Secretary Gould, under what circumstances would you support a merger of the insurance funds.

Mr. GOULD. Well, I have tried to define in my prior testimony what sort of flesh-out, if you will, what the merger of the funds entails by——

Mr. WORTLEY. In other words, if this recapitalization program does not fly by the Congress, Chairman Gray.

Mr. GOULD. I have said that the Treasury priorities are simple. They have a three tiered approach to this.

The first is Federal Savings and Loan Insurance Corporation recap, which is a function of self-help by the industry—no taxpayers involvement.

Failing that, our next priority was the concept of merging the funds, but in our concept of merging the funds, there would still be the necessity to raise money to solve Federal Savings and Loan Insurance Corporation's problems because we did not mean by the concept of merging the funds that we comingle the $18 or $19 bil-

lion of the Federal Deposit Insurance Corporation with the problems of the thrift industry.

So it depends a little bit, sir, on how you define merging. Ours required two separate funds and a differentiation of assessment that was our second priority.

Our third priority, and only in the case of systemic problems for the depositors in the thrift institutions, did we say that we would favor appropriating taxpayer money. I would say parenthetically here that the Federal Savings and Loan Insurance Corporation already has the $750 million line to the Treasury, but that is the limit of it and in this game, I fear that is a drop in the bucket.

Mr. WORTLEY. I would hope we would not have to go that route.

Mr. GOULD. Yes sir.

Mr. WORTLEY. Chairman Gray, the other day the American Banker reported that the San Francisco Federal Home Loan Bank was refusing to accept Federal Savings and Loan Insurance Corporation guarantees. Could this extend further than the San Francisco bank? Do you anticipate anything like this happening?

Mr. GRAY. I am not sure that is the case, that the San Francisco Bank——

Mr. WORTLEY. The American Banker was wrong?

Mr. GRAY. I understand, I would merely say this. Every board of directors of every Federal loan bank has a fiduciary responsibility to that Federal loan bank and when advances are requested and the initiative does come from the Federal home loan bank itself, not from Federal Savings and Loan Insurance Corporation, to deal with a liquidity problem in a very troubled institution, then they will say we will make a loan to that institution to maintain its liquidity, but the Federal Savings and Loan Insurance Corporation must guarantee it.

Now we have day one, we have $3.6 billion in advances which are guaranteed by the Federal Savings and Loan Insurance Corporation outstanding about $1.6 billion of that $3.6 billion is collateralized in one way or another. That leaves $2 billion that is uncollateralized and the Federal Savings and Loan Insurance Corporation reserves of the Federal Savings and Loan Insurance Corporation serve as the only security whatsoever for paying back that borrowing.

And we also, I might note, only have $1.9 billion in the primary reserve of the fund, but this is not the end of the story, we have, as I understand it, pending requests for guaranteed advances, Federal Savings and Loan Insurance Corporation guaranteed advances from the Federal home loan banks of $2 billion, and that indicates probably less than a half of that $2 billion would have any collateral whatsoever. So we could soon be in a position of having $3 billion in advances guaranteed without any collateral or more and the Federal Savings and Loan Insurance Corporation, of course, simply does not have the security to back that up in a very practical sense.

So it is a severe problem and one can understand why those who govern the Federal home loan banks with their particular fiduciary responsibility may well be very reluctant, very understanding they would come to us after a period of time for more advances that are

not really guaranteed at all because there aren't the funds to guarantee them. So it becomes fiction.

Mr. WORTLEY. There has been trouble out there and I appreciate the Chairman holding this hearing and getting this legislation moving forward. We better move with dispatch.

My time has expired.

The CHAIRMAN. Mr. Gonzalez.

Mr. GONZALEZ. Thank you very much, Mr. Chairman.

I have these three specific questions:

How much of the loss experienced by Federal Savings and Loan Insurance Corporation insured institutions in third quarter of 1986 are a result of the write-down of assets required by R. 41?

Mr. GRAY. I will have to respond very specifically for the record because I don't have those figures.

Mr. GONZALEZ. All right, I would appreciate that.

[At the present time the information referred to from the Federal Home Loan Bank Board is not available.]

Mr. GONZALEZ. The second one is, I understand that many institutions are having problems with the asset write-downs mandated by R. 41 standards, as applied to problem loans. Have you considered using a different standards, as applied to problem loans. Have you considered using a different standard for problem loans write-downs while retaining the full protection of strict appraisals for new loans.

Mr. GRAY. That is always a continuing process, Congressman, but with respect to I believe some comments to Congressman Bartlett, I have talked about the forbearance that we are exercising on a continual basis, particularly in the southwest, which we intend to continue to do.

Mr. GONZALEZ. All right, sir.

The third and final question: The United States League has requested, according to yesterday's testimony from the Bank Board policy statement, forbearance on capital requirements such as that or similar to that of the Comptroller's in the case of banks and specifically as of April 23 last year, have you thought, or have you issued such a statement, or do you think it likely that you would?

Mr. GRAY. Well, we certainly will consider anything that is brought before us. I am one of three members of the Bank Board and I did meet with representatives of the United States League. They told me that they had a suggested statement we certainly will take a look at that.

Mr. GOULD. I really do implore that you do so. I don't mind saying that back in my home State of Texas, I am not just speaking of a handful of institutions that are very, very bitterly feeling that the Federal Home Loan Bank Board has been red lining Texas, so to speak, in considering these very serious problem situations that they confront now.

I have requested specific cases and information and will expect to be in touch with you the moment that I do have any documentation.

Mr. GRAY. Let me just say that in that connection, I just categorically object to the idea that the Federal Home Loan Bank Board is in any way, shape or form red lining Texas. Frankly, that is absurd. I almost don't even want to dignify the suggestion and you

are just passing on what you have heard, that we are red lining Texas. That is not true at all.

Mr. GONZALEZ. I yield.

Mr. GRAY. We are trying to treat every State alike.

Mr. GONZALEZ. I did ask and raised that issue because, as I said, it wasn't one or two disgruntled or disappointed institutional officers, but quite a number, and more than in my own area, and let me say that I think you know well that I have spoken of my high regard and have felt very—what should I say?

Mr. GRAY. Supportive.

Mr. GONZALEZ. Well, I mean about the statements. I have been questioning and I have raised that as an issue, given my relations since you came aboard and since I have been on this committee, and it seems as if on two occasions—one of them in Dallas, TX of all places. Dallas has the other part of Texas—no affront to my colleague from Big D. I am from San Antonio, and that is a sort of free State of Bear County, and almost turned out to be fighting words. One fellow said, who are you representing, Texas or Northerners, and I said, no, he is not, he is from California. He is a westerner, am I right?

Mr. GRAY. I am a westerner, born Texan. My father was from Texas.

Mr. GONZALEZ. That will shock them, and it will help me. I thought I would raise the issue because this is—in fact I don't mind saying it led to a discussion with the Attorney General of Texas, who has been under considerable pressure in that respect. So thank you very much, Mr. Chairman, for your generosity. Your grandfather didn't fight at the Alamo.

Incidentally, the Alamo is in the middle of my district. When anybody tries to press me hard on that, I say I have ancestors who fought on both sides.

Mr. GRAY. I just want to say——

Mr. GONZALEZ. That is literally true. Not specifically at the Alamo, but my great grandfather was the North Mexico co-leader against General Santana, and it was after Santana put them down that he came to Texas. So we were fighting in a way the same forces.

The CHAIRMAN. Mr. Bartlett.

Mr. BARTLETT. Thank you, Mr. Chairman.

I am going to try another pass at the amortization of loan losses and Chairman Gray, I want to say we have worked together on a lot of issues and worked quite well, so please I will ask the same question of Secretary Gould but please let me try to make the question clear and please don't be defensive about the word "forbearance". I will try to ask the question without using that word if it bothers you.

The Bank Board is exercising in my judgment the Texas, and Chairman Gonzalez would concur, a great deal of forbearance in not closing institutions. But my question is that do you believe you should have the ability which you do not now have, to amortize loan losses over a multi-year period of time so as not to have this one set of a hundred percent drop in collateral value on the books, put a savings and loan with a negative net worth. The Bank Board is not using FASB 15 for a variety of reasons, and it is not lack of

interest or want to, but you are not using it today because you cannot. It is too clumsy.

So my question is, should this committee—would you work with this committee if this committee could develop a mechanism to amortize those loan losses particularly in circumstances where you have a hundred percent collateral loan value, so you don't end up with large negative net worths to add to your problems.

The question is not whether you close the institutions down that you can save, you are not. The question is, how those loan losses are placed on the books. Would you work us in constructing a way to handle that?

Mr. GRAY. I would be delighted to. But let me say if you are talking about instances where the institution was already beyond redemption, if you will, before we began to have the problems in the depressed economies, I am talking about in the last year, would you agree basically within the last year?

Mr. BARTLETT. That is when the collapse in collateral values happened. I am not talking about those institutions, though, Chairman Gray. In fact, I would suggest we have an objective or quantitative methodology so the Board is not in the position of choosing good versus bad guys. I think that is the wrong approach.

I will suggest a way to amortize loan losses that applies to everybody. Those institutions then that were overly aggressive in direct investments and that is a euphemism for it, and were already in trouble before the drop of loan values, they can get their amortization of loan losses but it may be of no help because it may be just too far gone.

But there were many institutions that were not—the loan collateral values have dropped absolutely through the seller. The values will come back. It is the board's intention and practice to not dump that real estate on the market and I encourage you to stay to that practice, but to work that real estate out over, to get it to earning income over a multi-year period of time, and all we are asking is to amortize in those losses that you have to realize, amortize over a period of time so you don't have to show a negative net worth and give you some extra ability.

Secretary Gould?

Mr. GOULD. Well, Congressman Bartlett, I guess I would have several things to say about it. First of all, we were supportive of bank regulators when they looked at agriculture and energy loans in terms of forbearance and said indeed they have the tools to do it, but did not need legislation, but there was a definition of forbearance inherent in that which is worth looking at. In fact the OCC and the FDIC required in order to give forbearance on capital, to ask the institution to come forward with a 5-year business plan which gave the regulators a sense of whether it was really possible for them to come out of this problem into which they have themselves stuck.

In other words, that is a way of defining forbearance as applying to those people caught in cyclical downturns, in agriculture, energy, real estate, where there was a reasonable expectation that a return of an up cycle would straighten out the difficulties and they were not pieces that no amount of millennium could ever drag out of the bad judgment they had exercised before.

So that was an important differentiation.

As to this specific case, my understanding of FASB 15 is it is an existing rule of the Accounting Board, of FASBI. The way FASB 15 functions is it allows you to restructure a loan so you, if you get back the principal of the loan, however divided between principal, and interest over the term of that loan, you do not have to write the loan down. This is a very flexible tool on the books to allow restructuring of loans to fit the needs of the borrower in adverse conditions without it impacting back on the bank in terms of writing it down.

You might write off 30 percent of the principal, make it up in interest, vice versa, but it is out there and can be and should be used when it is applicable.

As to writing off losses realized or recognized over long periods of time, and here I don't wish to pose as an expert because indeed I am not, but I thought that was already inherent in the regulatory accounting by which this industry has largely measured itself. We have talked about moving to Generally Accepted Accounting Standards as inducing greater public trust and calling it as it is, sort of approach.

I would just point out that there are groups of people who say we ought to move to GAP, we ought to move to stronger accounting standards for the S&L industry, matching those already used in the commercial banking industry, I might say.

But that talking about long lost amortization is in fact a step away from that and maybe it is worth while, maybe it is important, but it is a deviation from that test.

Mr. GRAY. Let me just add that it would be incorrect, I think, to say that the Bank Board uses or doesn't use or isn't allowing, whatever, the use of FASB 15. That is a device for savings and loans themselves. They can in fact use FASB 15 under our rules. But you have to understand that acquisition, development and construction loans which have caused by far our biggest problems in Texas and elsewhere, can rarely be restructured to comply with FASBI because the borrower has never had any equity anyway really. So it is difficult to use FASBI in those cases.

But I will just say, I of course would look forward to working closely with you, recognizing these problems and any time we are available to meet with you and discuss this in great detail, we will.

Mr. BARTLETT. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. The Chair asks unanimous consent to insert into the record at the conclusion of this hearing, which we are now at, a letter to me dated January 9, 1986 from the Texas Savings and Loan League, that among other things at page 4 of its attachment includes a discussion of the FSLIC recapitalization issue.

Is there objection? The Chair hears none.

[The letter of January 9, 1986 can be found in the appendix.]

The CHAIRMAN. Gentlemen, we want to thank you for your assistance this morning and afternoon. We will have further questions that we will be submitting to you in writing from members who couldn't be here all morning and this afternoon while we conducted this hearing.

Mr. McCOLLUM. Can I? I was here all morning and I just couldn't be here at 2 o'clock, Mr. Chairman. I would really appreciate it. It would only take me a minute.

The CHAIRMAN. OK.

Mr. McCOLLUM. I apologize but I just couldn't be here at that particular hour.

The CHAIRMAN. I cancelled a meeting with the Speaker of all the Chairmen to be here.

Mr. McCOLLUM. I understand that, Mr. Chairman, but I did sit in here a lot today and if I just walked in, period, I would not feel that way.

The CHAIRMAN. Go ahead.

Mr. McCOLLUM. Mr. Gray, I just wanted to ask a follow-up question to a lot that I heard discussed earlier as I did sit here, about these exit fee questions. And about the questions pertaining to the issue of movement of people out of the fund from the FSLIC to the FDIC.

My concern has been, and I am sure I think both you gentlemen are aware, Mr. Gould, you and I discussed this, is not so much with savings and loans switching or converting to banks. I really don't have a problem that although I understand it could present problems if too many ran off. Obviously that could happen. I do not feel though that legislatively we thought to restrict that. Perhaps exit fees would be appropriate as you discussed because of the loss that might be incurred in that area.

But what concerns me is while there are still savings and loans remaining, switching over and using the FDIC when the FSLIC really needs them to be a participant. Because of that I, last time we had a markup, I attempted to try to put some inhibitions into the legislation to either absolutely bar or later in some other form make them think twice about simply switching, not converting.

What do you feel about that?

The CHAIRMAN. If the gentleman would yield.

Mr. McCOLLUM. Yes, Mr. Chairman.

The CHAIRMAN. What we did a few minutes ago is ask Mr. Gould on behalf of Treasury to submit a memorandum, because they had not testified as to their opinion on this and he has agreed to submit a written memorandum on this, so we can then have the benefit of Treasury, the Home Loan Bank Board plus the industry recommendations in this area.

Mr. McCOLLUM. Very good. I really appreciate that.

Mr. Gray, I think you supported some inhibitions or restrictions in that respect, did you not, at one time?

Mr. GRAY. What I have always supported is having a viable FSLIC recapitalization plan. If the impression was erroneously left that I favored a Berlin Wall then that would not be correct. What I do favor is assuring that there is sufficient compensation when an institution leaves.

Mr. McCOLLUM. When it leaves to become a bank or when it leaves to go from the FSLIC to the FDIC?

Mr. GRAY. When it leaves our premium stream system.

Mr. McCOLLUM. Whichever way it goes?

Mr. GRAY. Right. If they are not going to be paying premiums at a certain point to the FSLIC then I become concerned only because

I want to make sure there is compensation to keep this plan whole over the long term.

Mr. McCollum. I wanted to clarify that.

Mr. Gould, you will submit a memorandum so that will be fine.

Mr. Gould. Yes, sir.

Mr. McCollum. One last question that I wanted to ask, Mr. Gray. There have been a large number of complaints to me from people who are in Florida which naturally they would be, now starting up savings and loans, the ones that are actually off the ground now that I am talking about. The newer ones that are there say they feel that the Home Loan Bank Board in Atlanta, perhaps your shop, have gone a little further than necessary in restricting their growth, not in the way that they are out of some area that you have been restricting their participation in, but in areas where they are allowed to participate, by the manner in which their plans have been set, they say you can have only so much capital asset expansion for this year and over the next 2 or 3 years.

Have you had anybody discuss that with you? Has that been a problem?

Mr. Gray. No, I have not. If you are talking about de novo institutions——

Mr. McCollum. I am.

Mr. Gray. All right. All institutions operate under our regulations.

Mr. McCollum. Absolutely.

Mr. Gray. I mean whether they are de novos or whether they are large or small. I am not personally aware of anything that the Atlanta bank would be doing—and I haven't heard anything—which would in any way depart from the regulations that affect all institutions.

Mr. McCollum. What concerns me about it, and I will submit any particulars to you, I didn't want to plead an individual case, but what concerns me is if we don't have growth in the institutions that are sound and have plans that have been generally approved and we restrict these de novos too much that we will not be able to fund the FSLIC. That is my problem.

You have to have somebody getting out there getting healthy in a big way.

Mr. Gray. I am very pleased to tell you that over the last several years for those de novo institutions which have been chartered in just these last seven years, that we see a good deal of health and we see high levels of net worth.

Mr. McCollum. Yes. That is what I see, too, and it just bothered me that more than one has said that. But individually I will submit some of that to you. I was looking at a policy question here and I appreciate the opportunity to ask the questions. Thank you, Mr. Chairman.

Thank you for your patience.

Mr. Gould. Mr. Chairman, might I submit something for the record?

The Chairman. Well, what is it?

Mr. Gould. You asked me this morning, I referred to letters from investment bankers.

The Chairman. Yes.

Mr. GOULD. And I said I would submit them to you. I find we have them here and if I may I would like to leave them with you.

The CHAIRMAN. Your staff is working expeditiously.

Mr. GOULD. Very quickly even in the snow, sir.

The CHAIRMAN. By golly, you got some huskies out there? Without objection.

[The letter from investment bankers furnished by Mr. Gould can be found in the appendix.]

The CHAIRMAN. We accept your submission by the Secretary.

Mr. GRAY. Let me just say that Rothchild and Company, a major New York Wall Street bond dealer, has done an appraisal of the FSLIC Bank Board plan and I believe they have done that in writing.

The CHAIRMAN. And which you will submit?

Mr. GRAY. I believe your staff has it.

The CHAIRMAN. Thank you.

Do you have any questions?

Mr. BUNNING. No questions, Mr. Chairman.

The CHAIRMAN. Mr. Bunning has no questions.

The Chair would like to thank both the Secretary and Chairman Gray for their assistance in this matter. I wish you well on your return trip to wherever you go. Let's hope we all get there safe and sound and not too wet. We will be submitting additional questions as I stated earlier, in writing for you to respond to.

We will continue to keep open our lines of communication so that we can do what has to be done in this area. And again, I don't think there is much press here. I think they abandoned us. We are going to move expeditiously but, by the same token, we are going to move with caution as well.

However, I think it is evident that we had these hearings early on, prior to the subcommittees having been chosen, because of the importance we attach to the situation that faces all of us.

With that the committee will stand in recess until Tuesday morning at 10 o'clock.

Mr. GOULD. Thank you for having us, Mr. Chairman.

Mr. GRAY. Thank you.

[Whereupon, at 3:15 p.m., the committee was adjourned, to reconvene at 10 a.m., on Tuesday, January 27, 1987.]

APPENDIX

~~FOR RELEASE ON DELIVERY~~
~~EXPECTED AT 11:00 a.m.~~
January 22, 1987

Testimony of the Honorable
George D. Gould
Under Secretary for Finance
U.S. Department of the Treasury
Before the
Committee on Banking, Finance and Urban Affairs

Mr. Chairman, Mr. Wylie, and Members of the Committee:

I am delighted to have the opportunity to testify before you today on our plan to recapitalize the Federal Savings and Loan Insurance Corporation (FSLIC). I am greatly encouraged by your early hearings. They are an indication that this Committee senses the urgent need to address immediate safety and soundness concerns, particularly those affecting the thrift industry.

In order to stress how strongly we believe that FSLIC recapitalization is necessary by early spring, we asked the bipartisan leadership of the Senate and House Banking Committees to reintroduce our proposed bill on the day tha new Congress convened. It is the same basic plan that passed both houses of Congress last year. Given the immediacy of tha problem I will describe, we cannot afford delay.

The Administration is committed to maintaining a safe and sound financial system -- especially where insured deposits are involved. The safety of consumers' insured savings is a critical issue for all Americans.

Size of the Problem

The problems affecting roughly 20 percent of the savings and loan industry are well known. I have testified on them extensively and consequently will focus my remarks today on the Federal Savings and Loan Insurance Corporation (FSLIC).

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The Federal Home Loan Bank Board (FHLBB) estimates that the FSLIC will need about $20 billion to resolve the problems of institutions in the FSLIC caseload, those considered significant supervisory cases and other anticipated cases. However, the FSLIC's total reserves at the end of December 1986 were only slightly over $3 billion $800 million of which is in FSLIC's secondary reserve and is carried as an asset on the books of the industry) and could fall rapidly to under $2 billion by the end of February 1987. When the Government Accounting Office (GAO audits the FSLIC's books, it may require the FSLIC to add to its reserves for losses and thus reduce reserves even further, quite possibly to a negative position. To obtain a "clean" accounting opinion for the year-end 1985 financial statement, the FSLIC was required to increase its provision for loss contingencies by $1.6 billion.

In 1987, the FSLIC expects to receive about $2.4 billion in total income, which includes regular premiums, special premiums, investment and other income. This sum fails even to cover the operating losses of about $2.6 billion per year piling up on FSLIC's caseload -- to say nothing of resolving some of these insolvent S&Ls. Delaying the resolution of problem institutions will significantly increase the FSLIC's ultimate cost.

In addition, the reduced size of the FSLIC reserves is already causing the FHL Banks to voice concern over their ability to accept the FSLIC's guarantees of advances loans) that the FHL Banks make to distressed institutions. The FSLIC has reported that the insolvent but still open) institutions will be forced to more aggressively solicit new deposits which will raise not only <u>their</u> cost of funds -- and the ultimate resolution costs to the FSLIC -- but also raise the cost of deposits for <u>all</u> depository institutions in local markets and beyond.

<u>Treasury's Three-Pronged Strategy</u>

In previous testimony I recommended a three-pronged strategy to help the thrift industry and the FSLIC. We still support this plan, which I want to briefly summarize for you now.

<u>First</u>, we have stated that we need to strengthen the thrift industry as a whole. To do this we encouraged the FHLBB to set targets and create incentives for the industry to increase its capital, and concurrently to halt the growth of the industry s problems through improved supervision. Last August the FHLBB adopted new standards for insured thrifts which phase-in higher capital requirements over time. The Board also has significantly increased the number and quality of examiners in an effort to improve supervision.

The second prong of our strategy was to lower the resolution cost that the FSLIC and the industry must pay by enhancing the franchise value of ailing thrifts and thus increasing the price acquirers are willing to pay for these thrifts. In the past year, the FHLBB has adopted regulations that increase the franchise value of insolvent thrifts by permitting acquiring savings and loans to expand into three additional states. More needs to be done. I will discuss this part of our strategy more fully later in my testimony.

Third, we called for increasing the FSLIC's resources so that it could handle a greater number of insolvent institutions in the next several years. The time to act is now. The low interest rate environment has enabled most of the industry to have high earnings. Every day we wait, FSLIC estimates its costs increase by $6 million. (A detailed description of the recapitalization plan is attached.)

The Treasury/FHLBB FSLIC Recapitalization Plan

In devising our plan to recapitalize the FSLIC, two simple requirements were uppermost in our minds.

First, the time-tested notion of self-help was vital. The taxpayer must not be called upon to bail out an industry that with some measure of sacrifice over time can help itself. After all many thrifts have profited greatly from their franchise and they probably were paying too small an insurance premium in the past.

Second, the recapitalization plan must have enough resources available up front to meet the real problems we all recognize today. To this end the FHLBB, the Federal Home Loan Bank System, and the Treasury devised a unique industry-based plan that would enable the FSLIC to devote about $25 to $30 billion over 5 years to handling its sizeable load of problem cases, while in all likelihood being able to phase-out the special premium assessment over the same period.

I am pleased to note that our plan has been endorsed again by many responsible people in the thrift industry who share our concerns. We welcome the strong support of groups like the National Council of Savings Institutions and the New England League of Savings Institutions.

Briefly, under our plan the FHLBB would charter a Financing Corporation which would be capitalized with up to $3 billion of the FHL Bank System's surplus over five to six years.

The Financing Corporation then would borrow up to $15 billion by issuing long-term bonds over the five-to-six-year period as the funds were needed by FSLIC. It would assure payment of the bonds' principal by using up to $2.2 billion (of the $3 billion) of the FHL Banks' investment to purchase long-term, zero coupon instruments, which at maturity would equal the bonds' principal. (The remaining $800 million from the FHLBanks' investment would serve as a special "interest reserve" to ensure the phase-down of the special assessment even under adverse circumstances.) The interest on the bonds would be paid by the Financing Corporation through assessments. Each insured institution would pay in an amount not to exceed 1/12 of one percent of an institution's total deposits unless the FHLBB determines an additional amount up to 1/8 of one percent of deposits is necessary. In other words, the Financing Corporation could have the authority to use all of the FSLIC s current premium and special assessment income. Any assessments made by the Financing Corporation would reduce FSLIC's assessment authority dollar-for-dollar.

The Financing Corporation would then invest the $15 billion it raises in nonvoting capital stock and nonredeemable capital certificates of the FSLIC.

The FSLIC would thus have available the $15 billion, the annual premium income in excess of interest costs (phased down over five years), income from investments and reflows from the sale of assets acquired from resolving cases or a total of $25 to $30 billion over 5 to 6 years) to resolve the problem cases.

Some members of the industry argue that the FSLIC could not efficiently use more than $1.8 to $2.0 billion in any one year to resolve problem institutions. This is not true. The FSLIC's case resolutions in 1986 cost about $3.0 billion. This money was used to resolve 51 cases with about $23.9 billion in assets. FSLIC could have done more if it weren't concerned about maintaining a cushion of reserves.

To assist in liquidating these assets at the highest price for the FSLIC, the FHLBB in November 1985 chartered the Federal Asset Disposition Association (FADA). The FADA is a nonprofit organization that has been responsible for disposing of the more complex and large properties the FSLIC has acquired from failed institutions. The FADA does not take title to any assets, but now has about $2.02 billion under its management.

The Treasury/FHLBB plan was carefully designed so that the money injected into the FSLIC would be an offsetting collection rather than a borrowing for budgetary purposes, so as to offset outlays for case resolutions. Therefore, our plan provides $15 billion of extra budget receipts (beyond assessment income) over 5 years.

Nearly one year ago, Congress asked us to provide a solution for the problem of declining FSLIC resources. We supplied a workable plan which is industry-based and gets the job done now. Our plan gets the money into FSLIC as needed. It phases out the special assessment, protects the integrity of the FHL Banks, and safeguards the interests of the FDIC members of the FHL Banks. We have presented a plan that makes good sense from a budgetary perspective.

In the final analysis, no one wants to see depositors standing in lines, like they did in Ohio and Maryland where state-chartered insurance funds were not equipped to meet the challenges arising from problem institutions. It is time for Congress to act.

For these reasons, we hope you will move this critically important legislation, which both houses of Congress passed on the last legislative day last year, quickly and cleanly through the new Congress so that it can become law by this spring.

FSLIC cannot wait.

<u>Problems of Industry Alternatives</u>

The U.S. League's plan for solving the rapidly shrinking FSLIC fund is similar to inadequately repairing dangerously decaying streets. It only patches the potholes (so the problem will occur again and be even larger) instead of rebuilding and then resurfacing the whole road bed. Moreover, it leaves FSLIC in a state of shock, shakes up the FHL Banks, and jolts the nation's depositors -- all because the League's plan neglects timely repairs.

<u>The League's plan provides insufficient funds.</u> The plan at best provides $5 billion. A close look at the plan reveals it would even condition raising this $5 billion on FSLIC's cash (liquidity) position, not its reserves (FSLIC's capital). But the FSLIC can have cash with zero or negative reserves because liabilities exceed assets). What good is a plan that may not provide funds until after the public knows the FSLIC is out of reserves?

The longer the resolutions of insolvent thrifts are postponed, the greater the ultimate cost will be. The logic is straightforward: if an insolvent thrift is suffering operating losses, systemic -- that is, FSLIC's -- losses are building.

The plan is a "pray-as-you-go" plan: the longer the resolution of failing thrifts is postponed the greater the risk that interest rates will rise. Higher interest rates would raise the FSLIC's resolution costs enormously. The cost of deposits would rise, increasing operating lossess and decreasing the value of some assets.

A GAO study in September 1986 found that a 2 percentage point rise in interest rates would cost the FSLIC an additional $7 billion in resolution costs over the next two years. Lower interest rates are not going to help S&L's with problem loans that are based on poor quality.

The League's plan may not even produce the $5 billion. It is hard for new corporations to issue 20-year bonds. It gets even harder to sell 20 year zero coupon bonds because the investor has to wait 20 years before he gets one cent back. When the sources of repayment are as vague as the League proposes -- a share of the FHL Banks' earnings supplemented in some fashion from the industry -- the debt looks speculative at best.

In contrast, the Treasury/FHLBB plan issues regular bonds and can assure the bondholders' principal from day one by buying Treasury zero coupons.

Despite the speculative nature of the League's zero coupon bonds, it assumes an 8 percent interest rate. This is unrealistically low.

The League's plan places a vague (but likely very large) future burden on the industry to cover interest costs with extra assessments. (A higher borrowing rate than they have assumed would make these huge.) In contrast, the Treasury/FHLBB plan includes a clearly evident phase-down of the special assessment over 5 years, backed by an extra $800 million interest reserve cushion.

The League's plan is inefficient: it would raise less and cost more. The League's own worksheets reveal that it would raise only 1/3 of the money for over 1/2 of the cost of the Treasury plan.

The burden imposed on both the FHL Banks and the industry (with uncertain future assessments) by the League's inefficient venture would make it extremely hard or impossible to call on either to help, if FSLIC needs more than $5 billion (as we already know it does).

The League's plan weakens the stability of the FHLBank System. The plan draws from the FHL Banks an annual $275 million or 20 percent of earnings, whichever is larger, for 20 years. The 20 percent of earnings is the statutory requirement for legal reserves, so for 20 years the FHL Banks cannot build reserves that are required by law for safety and soundness.

If the FHL Banks were to get into trouble, they would have to reduce dividends to their members or in the extreme, seek to draw on a conditional $4 billion line of credit with Treasury.

The plan would also demand more from the FHL Banks with FDIC-insured members primarily in the Northeast, Mid Atlantic, and Far West) in contrast with the Treasury/FHLBB plan.

The League's plan increases the real risk of a liquidity crisis at some institutions. As stated earlier, the FHL Banks may find they can no longer accept the FSLIC's guarantee of advances (loans) made to troubled thrifts.

In summary, the U.S. League's plan raises too little money in an inefficient manner that puts long-term strains on the FHL Banks.

First, the League denied there was a problem. Then they killed the 1% recapitalization proposal. Now they have a phoney proposal to stop a real recapitalization of FSLIC Finally, they try to hide behind assertions that FSLIC's problems are not really that bad and that there are not costs of delaying its existing caseload.

In our view, it is high time to fulfill our joint responsibility to protect America's thrift depositors. I urge you to reject calls for further delay more study, and toying with grand schemes that fall short of providing FSLIC with the necessary funds to carry out its insurance functions.

Some people have suggested that the solution to FSLIC's funding problems is to merge the two federal deposit insurance funds. Let me assure this Committee that the Treasury Department has no hidden agenda to merge the funds.

It is true we have stated that failing substantial success to enact our FSLIC recap plan, the concept of merging FSLIC and FDIC comes ahead of using taxpayer money, which would be a last resort only to prevent systemic problems for depositors. It may be useful to clarify precisely what this merger would mean:

- there still would be two funds, not one commingled entity -- the merger would be at the regulatory level;

- money still would be needed up front and still would have to be borrowed FDIC's reserves would not be available except possibly as a backstop for an FDIC guarantee of the "thrift fund" borrowings);

- the S&L industry still would not avoid the costs -- a premium differential is inevitable; and

- debate and negotiation would be time consuming and extremely difficult, contributing to uncertainty in the marketplace.

Encouraging the Flow of Private Capital into the Thrift Industry

Another part of reducing the long-term cost of solving the problem of failing thrifts is to encourage bank holding companies, financial services firms, and others to acquire them. The FHLBB has reported that the cost of merging failing or failed thrifts for 1981 to 1986 ranged between 4.2 percent of assets to 7 3 percent. Liquidation costs varied from 21.9 percent of assets in 1983 to 45.7 percent in 1986. The Federal Reserve Board FRB has moved cautiously in permitting bank holding companies to acquire insolvent thrifts, and the FRB's tandem restrictions on BHC's acquisitions of ailing thrifts are exceedingly stringent. When the FRB last May asked for public comment, we encouraged them to review carefully their restrictions and liberalize them to attain more reasonable standards. We are still waiting for FRB action.

The FRB's regulatory separation between an acquired thrift and other subsidiaries is much greater than that between the BHC's bank and other subsidiaries. These rules are vestiges of acquisitions during an earlier era when statutory interest rate differentials were in place, and before interstate banking compacts took hold. In addition, "tandem" restrictions make thrift acquisitions exceedingly less attractive and strike a blow against consumers by prohibiting crossmarketing and other business connections that improve service and competition. Perhaps the FRB is in part waiting for signals from Congress with respect to the current usefulness of such restrictions.

The unitary thrift holding company is an example -- with over 20 years of proven history -- of how nonfinancial institutions have added capital to the industry by purchasing failing and non-failing thrifts.

We recognize that interindustry thrift acquisitions are a touchy subject, especially for some segments of the industry that wish to avoid competition. But the acquisition logic is straightforward and undeniable. The problem institutions have created real costs that the FSLIC the industry, and the consumer must bear. A broader range of purchasers can help FSLIC lower these costs by reducing the costs of dispositions. And they can bring additional capital to an industry that needs it badly.

In summary, we urge Congress and the regulators to accommodate new acquirers of insolvent thrifts. If we are concerned about business ties, we should cope with them through regulation of affiliate transactions and conflicts of interest, not through prohibition of ownership.

Conclusion

In closing, Mr. Chairman, I strongly encourage you and your colleagues to give the highest priority to our FSLIC recapitalization proposal. Then, after we have addressed these urgent safety and soundness concerns, we should work jointly toward a fundamental restructuring of our financial services industry so we can meet the challenges of the changing marketplace successfully and safely.

As Treasury Secretary James Baker stated just last week:

> It's time for a change. America needs to reassert itself on the leading edge of the financial services world. We've got the ability. We've got the motivation to do it. And we certainly have good reason to do it if we want to be internationally competitive.

We look forward to working closely with you and will assist you in any way that we can.

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Description of the Treasury/FHLBB Plan to Recapitalize the FSLIC

The Treasury and the Federal Home Loan Bank Board (FHLBB) developed this plan in alliance with the leadership of the twelve Federal Home Loan Banks (FHLBanks), whose contribution of up to $3 billion of capital is at the core of this effort to strengthen FSLIC. We also have worked closely with the leaders of the thrift industry. The result, is a proposal that will strengthen FSLIC, free FSLIC to resolve its problem cases more expeditiously, and increase depositor confidence.

Need for This Proposal

Estimates of the size of the problem confronting FSLIC vary widely. Most range from about $15 to $30 billion. The crux of the problem is that the assistance costs, even under the most conservative estimates, exceed FSLIC's present financial reserves.

If we do not recapitalize the fund, FSLIC would need to continue deferring the resolution of many problem S&Ls. This deferral would only increase the fund s ultimate costs With the appropriate financial and organizational resources, the FHLBB and FSLIC could set more ambitious targets and resolve more cases, more quickly.

This is a propitious time to act. The attractive interest rate environment provides the ideal window of opportunity to move ahead vigorously to deal with ailing S&Ls.

Action now on the thrift industry problem should reaffirm depositor confidence in the health and stability of depository institutions and the viability of the deposit insurance funds. Furthermore, prompt handling of the most debilitated S&Ls should help healthy S&Ls by lowering their cost of deposits, which have been bid up by the feeble S&Ls' call for funds at any price.

If we do not strengthen FSLIC now, we may place the S&L industry at considerable risk in the future should interest rates rise significantly.

Objectives Guiding the Recapitalization Proposal

Six major objectives guide our FSLIC recapitalization proposal.

First, the proposal balances the financing burden between the Federal Home Loan Banks (FHLBanks) and the S&Ls. The cost will be borne entirely by them, without any taxpayer funds.

Second, funds are transferred from these sources to FSLIC through a combination of assessments and stock purchases (most of which will be non-redeemable under all circumstances) to avoid a negative budgetary effect.

Third, this plan can supply up to $25-30 billion to FSLIC over the next 5 to 6 years, with approximately $15 billion available in the first 3 years. Given FSLIC's organizational constraints, this infusion probably represents the maximum level of resources that FSLIC can efficiently use to resolve problem cases. Because the plan is flexible by design, FSLIC need not draw this full amount if the size of the problem turns out to be at the low end of the estimated range.

Fourth, the funds transfer to FSLIC is not dependent on any U.S. Government or FSLIC guarantees of debt.

Fifth, the proposal seeks to accommodate the FHLBanks' concerns about a substantial increase in their debt costs and the accounting treatment of their capital contribution. It also recognizes that the allocation of contributions among the FHLBanks needs to take into account their proportions of FDIC-insured members.

Sixth, this plan addresses the S&L industry's overwhelming concern the continuation of the FSLIC special assessment -- by creating the substantial likelihood that this extra assessment can be phased out over the next five years. (The special assessment is one eighth of one percent of deposits, in addition to the regular assessment of one twelfth of one percent.) We believe it is important to show the high probability of eliminating this extra premium over time (even if the problem cost turns out to be $25 to $30 billion), because it is a heavy burden on the industry and this will tend to decrease the incentive for healthy thrifts to switch from FSLIC to FDIC insurance.

Description of the Proposal

In essence the recapitalization proposal leverages both the current earned surplus of the FHLBanks and future FSLIC assessments to get equity funds into FSLIC more quickly. A separate corporation (the "Financing Corporation") capitalized by the FHLBanks will undertake a specially designed financing over time to channel equity investments into FSLIC. The proposal contains important safeguards to ensure that both the principal and interest on the Financing Corporation's special borrowings will be repaid.

Most of the Financing Corporation's investment in FSLIC, however, will be in the form of non-redeemable capital certificates that will never be repaid. The remainder of the Financing Corporation's investment in FSLIC will be in the form of non-voting capital stock that may or may not be repaid, with or without a return, depending on FSLIC's financial performance (as measured through FSLIC's reserve-to-deposits ratio).

The key elements of the proposal are as follows:

- o The FHLBB charters a "Financing Corporation," capitalized with no more than $3 billion of the FHLBanks' surplus over about 5 to 6 years. (The FHLBanks had $1.8 billion in earned surplus at year-end 1985 and this is expected to increase to over $2.3 billion at year-end 1986.) The Financing Corporation will not have its own paid staff.

- o The Financing Corporation borrows approximately $15 billion through long-term bonds (15 to 30-year maturities) over these five to six years. It assures payment of these bonds' principal by using no more than $2.2 billion of the $3 billion to purchase long-term, zero-coupon instruments, which will equal the bond principal upon maturity and will be held in a separate segregated account. The remaining $800 million or more of the FHL Bank investment will be used to pay fees and interest costs. The Corporation will be subject to stringent limits on activities, leverage and life. (The FHLBanks estimate that the Corporation's debt will yield 50-75 basis points, a half to three quarters of a percentage point, above Treasuries of comparable maturity.)

- o The Financing Corporation then invests the same amount the FHLBanks invested in it (a maximum of $3 billion) in non-voting capital stock of FSLIC and an additional $10 billion (or more) in non-redeemable capital certificates of FSLIC.

- o The Financing Corporation would be given limited assessment authority over the FSLIC insured institutions The Financing Corporation would use the income raised through the assessments only for paying the interest on and issuance costs of the $15 billion of long-term bonds and for custodian fees for its segregated account holding zero coupon instruments.

- o The Financing Corporation's assessment authority would be further restricted to 1/12 of one percent of deposits, with exceptional authority to charge an additional 1/8 of one percent if the FHLBB gave its approval.

- The FSLIC's authority to assess premiums would be reduced by the amount of all Financing Corporation assessments for that year.

- FSLIC uses the assessment income not used by the Financing Corporation to add to its case resolution resources. The combination of equity, assessments, and earning on investments enables FSLIC to deploy about $15 billion in case resolution funds in the first 3 years and about $10 billion more over the next 2 years.

- The special assessment can be phased out gradually over 5 years, while still securing this $25 billion for FSLIC.

- The Financing Corporation would repay its debt principal (through the maturing zeros) around 2020. FSLIC would not be responsible for repaying this debt, nor would it be contingently liable for it.

- FSLIC would retire its outstanding stock, held by the Financing Corporation, after the Corporation repays all its debt. (The book value of the FSLIC stock could be as high as $3 billion, if the FHLBanks make their full capital contribution to the Corporation The payoff of both the book value and a return on this stock upon retirement would be totally dependent on FSLIC's financial performance (its reserve-to-deposits ratio). After 1996, if FSLIC's reserve-to-deposits ratio reaches certain levels, FSLIC would make contributions to an equity return account This account, which would be held by FSLIC until the Financing Corporation paid off all its debt, would be the sole source of funds for paying off the FSLIC stock. The non-redeemable capital certificates issued by FSLIC would be extinguished without any repayment.

- The Financing Corporation must sunset by 2026 (or earlier if it has repaid all its debt); its ability to borrow net new funds would end in 1996.

- The attached diagrams illustrate how the proposal would operate.

Flexibility of the Proposal

This proposal incorporates some flexibility in the event the industry problem is larger than estimated and FSLIC needs more funds. Alternatively, the structure could employ less funds from the FHLBanks and the industry if the problem proves less costly.

First, in the event interest rates rise, the face value of the zero-coupon instruments (the value at maturity) that can be purchased by the Financing Corporation will increase. More face value can be acquired because a zero-coupon instrument in effect pays off all interest, at a compounded rate, together with the amount originally invested, when the instrument matures; so a higher interest rate compounded over time will produce a higher face value amount of a zero-coupon instrument for a given initial investment. This increased amount at maturity would enable the Financing Corporation to use its initial capital to back a larger amount of borrowings.

Second, the Financing Corporation could generate a larger payoff from the zero-coupon instruments it purchases by selecting ones with longer maturities (more years to compound the interest).

Third, if FSLIC needs more money earlier, the FHL Banks could invest a greater percentage of their $3 billion in surplus in the first several years. Currently, we have the FHL Banks' investment spread out over a seven year period.

Fourth, currently, the plan calls for $800 million of the FHL Banks' $3 billion investment in the Financing Corporation to be set aside in a reserve to pay for interest and other expenses. This amount could be used to purchase additional zero coupon bonds to pay the principal of increased borrowing if necessary.

Fifth, if absolutely necessary, FSLIC could maintain a portion of the special assessment. While FSLIC should preserve this additional assessment authority, its use beyond the 5-year phaseout should be avoided if at all possible.

Budgetary Treatment

This proposal is structured carefully to create fair and appropriate budgetary receipts that will offset FSLIC's case resolution costs (which are scored as budgetary outlays).

Last year the Congressional Budget Office CBO), with the concurrence of the General Accounting Office (GAO), ruled that it would score as offsetting collections the full amount of funds provided to the FSLIC by the financing corporation. The recapitalization of the FSLIC will not be counted as federal borrowing by CBO.

Benefits

To summarize the benefits of this FSLIC recapitalization proposal

o FSLIC will be able to employ about $25 billion over 5 years to resolve its case load of problem thrifts. These funds should be transferred to FSLIC about as quickly as we can reasonably expect the FSLIC organization to handle its problem cases effectively.

- By handling insolvent S&Ls more expeditiously, FSLIC can halt the expansion of the problem.

- The certain availability of about $25 billion for FSLIC should increase depositor confidence. This confidence, plus the sale, merger, or liquidation of the weakest S&Ls, should help the industry lower its cost of funds.

- The FSLIC recapitalization burden will be shared fairly between the S&Ls and the FHLBanks. Moreover, the contributions are structured to minimize the adverse effects on both. There is a high probability that the special assessment on the S&L industry can be phased out over 5 years.

- Regular FHLBank debt should be protected from possibly higher borrower spreads.

- The legislation requiring the FHLBanks' investment in the Financing Corporation would resolve the FHLBanks' concerns about fulfilling fiduciary duties.

- The equity nature of the FHLBanks' capital contribution to the Financing Corporation — which links the repayment of the stock and the possibilities of higher returns to FSLIC's financial performance — should ease the FHLBanks' accounting treatment. Moreover, it gives the FHLBanks (whose Presidents are the FHLBB's principal supervisory agents for each district) an additional future economic interest in the condition of FSLIC and the industry.

- The formula that governs the FHLBanks' capital contribution will accommodate FHLBanks with a large percentage of FDIC-insured members.

- Finally, the flexibility built into the proposal permits the FHLBB to raise a range of funds for FSLIC, depending on FSLIC's needs.

STATEMENT OF

EDWIN J. GRAY, CHAIRMAN

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 22, 1987

I. INTRODUCTION AND OVERVIEW

Mr. Chairman, and distinguished Members of the Committee:

Thank you for inviting me to this very important hearing.

Nothing, simply nothing, is more important to the maintenance of a sound financial system than the maintenance of public confidence in it.

In my opinion, that is the real issue we are here to discuss as we approach the issue of recapitalization of the thrift deposit insurance fund.

None of us can afford to forget the nature and consequences of the loss of public confidence which occurred in connection with the Ohio and Maryland thrift crises. The public did, in fact, lose confidence in the backup mechanisms which had been instituted to safeguard the funds of depositors in the Maryland and Ohio systems. And, the repercussions of these thrift cases were felt far beyond the borders of the two states involved.

I believe we must address the issue of public confidence in the nation's federally-insured thrift system with dispatch -- and in a decisive manner which conveys maximum certainty to the public that the problems of the thrift deposit insurance fund, namely the FSLIC, are being dealt with in a way that merits their full confidence in the thrift system. This includes not only the maintenance of adequate financial resources to assure the health of the system but also the commitment and resolve of regulators and legislators alike to assure the integrity of the regulatory process so that federally insured fiduciaries of other people's money employ such funds in a safe and sound and prudent -- yes responsible -- manner.

We are not here today because of the kinds of problems which beset the FSLIC back in 1981 and 1982 when the costs of money being paid by thrifts was rapidly exceeding the return on largely lesser-yielding fixed-rate mortgage assets. The thrift insurance fund was able to deal with those kinds of problems at relatively far less cost. Since then, interest rates have receded very substantially.

Today, the underlying problem is that of poor quality assets which, in too many cases, have resulted from risky loans and highly speculative investments which have gone sour. Many of these assets at severely troubled institutions did not come about because of the energy problem in some states. They were bad assets before the price of oil tumbled. The effect of oil prices on some economies merely further exacerbated the difficulties involving such assets.

In this connection, we are exercising considerable discretion in our efforts to work closely and constructively with responsible thrift institution managements that are operating in depressed economies, particularly in the southwest. We are taking into strong account the nature of the difficulties they face in such economies, and where we reasonably can we are seeking to exercise appropriate forebearance, especially in cases where there is good management and the likelihood that such institutions can be turned around and restored to health.

I want to emphasize that roughly four out of every five FSLIC-insured institutions are operating profitably. The latest figures we have, for the first three quarters of 1986, show that the profitable sector of the industry earned $6.9 billion for that period, which is only $500 million less than the earnings of the profitable sector of the business during all of 1985.

On the other hand, the unprofitable, and therefore troubled, sector of the industry -- that is to say, roughly one-fifth of the industry -- ran up losses in the first three quarters of 1986 of $5 billion, up from $3.6 billion for all of 1985.

Nevertheless, the fact is the profitable sector -- the vast majority of the industry -- is <u>highly</u> profitable. This is a fact everyone must keep fully in mind as we approach the issue of FSLIC recapitalization. Despite suggestions by some that the thrift industry is "on the rocks" and "going down the tubes" the facts belie such "doom" scenarios. Again, the profitability of the vast majority of the industry tells me that the industry is worth saving.

Because the profitable sector of the industry must bear the brunt of depositor perceptions about the unprofitable sector, the industry as a whole is paying far higher rates for deposits than it otherwise would or should. Indeed, a study we completed last year showed that the thrift industry as a whole was paying at least $4 billion a year more than necessary precise y because of market concerns about troubled thrifts and negative perceptions of the FSLIC deriving from its weakened condition. The higher rates paid for deposits by the industry -- and all institutions, healthy or unhealthy, are affected -- come right off the bottom line and therefore hurt the profitability of the industry as a whole.

The spillover effects of a weak, thoroughly inadequate thrift deposit insurance fund, which is incapable of resolving severely troubled, terminally-ill thrift cases because it doesn't even begin to have the financial resources to do so, is affecting public confidence in the thrift system as a whole in a detrimental and an all too pervasive manner.

The public is clearly very much aware of the inadequate resources of the FSLIC and, as a result, the entire thrift industry is paying a heavy price in the premium rates it must offer to attract and retain deposits. Severely troubled thrifts, so long as they rema n open, have no choice but to continue their operations with exceedingly high-cost deposits if they are to maintain liquidity. This is a self-defeating proposition because the higher the cost of such operating funds, and by this I mean deposits, the more difficult it is to reach profitability, hence the higher likelihood of such cases ultimately requiring FSLIC assistance.

Both the FSLIC and Federal Home Loan Banks are directly affected by the liquidity needs of seriously troubled thrifts. In an effort to lend these thrifts funds to maintain liquidity, the Federal Home Loan Banks require that the loans ("advances") be guaranteed by the FSLIC. There are $3.6 billion in FSLIC-guaranteed advances outstanding but only $1.6 billion are secured by collateral from the thrifts. This means there is no security behind $2 billion in such FSLIC guaranteed advances except the primary reserves of the FSLIC, itself. Since the FSLIC has only $1.9 billion in primary reserves, a call on these advances by the Federal Home Loan Banks would wipe out the primary reserve. This demonstrates the non-existent margin between FSLIC-guaranteed advances and current primary reserves which guarantee such Federal Home Loan Bank advances. Indeed, another $2 billion in requests for FSLIC-guaranteed advances are pending. If approved, they would raise the uncollateralized portion of such FSLIC-guaranteed advances to over $3 billion, more than a billion dollars more than currently exists in the primary reserves of the insurance fund.

The 347 thrift institutions currently in our significant supervisory caseload, which includes 167 FSLIC cases, are losing $6 million a day, every day of the year, on an operating basis. These operating losses total $2.2 billion, more than the FSLIC's 1986 income. Thus, without recapitalization of the thrift insurance fund, the FSLIC can hardly "tread water," let alone resolve cases of failing institutions.

Early in 1985, the Bank Board, in its role as operating head of the FSLIC, commenced the full exercise of its statutory authority to augment the reserves of the fund by assessing a "special (prem um) assessment" on all FSLIC-insured institutions. This assessment, which amounts to 1/8 of one percent of deposits, added a billion dollars to the fund's reserves in 1985 and $1.1 billion in 1986. The special assessment is in addition to the regular premium paid yearly by insured institutions. The regular premium is 1/12 of one percent of deposits. It provided the FSLIC $704 million in 1985 and $748 million in 1986.

As mentioned previously, the primary reserves in the fund today stand at $1.9 billion. Today, the ratio of primary reserves-to-deposits is 21 one hundredths of one percent, an all-time low.

From early on in my tenure at the Bank Board, I have sought to keep the Congress and the thrift industry apprised of the weakening condition of the insurance fund, including the steadily deteriorating reserves of the fund and the declining ratio of FSLIC reserves-to-deposits. Some in the industry have, over the course of my time in office, admonished me not to talk about the fund's weakening condition, apparently in hopes that by sweeping the problem under the rug it would somehow go away. I did not take that advice.

Indeed, I have warned repeatedly since late in 1983 of my deep concerns about the worsening condition of the thrift fund.

In the late summer of 1985, after coming to the conclusion that the additional "special assessment" would not be sufficient to deal with the FSLIC's problems out into the future, I called for a recapitalization of the fund during a formal speech before the Annual Convention of the California League of Savings Institutions. In October, 1985, I testified to the Congress that the fund would have to be recapitalized and that the only two sources I knew of were the thrift industry or the taxpayers. I have continually opposed the notion of a taxpayer bailout.

In early January, 1986, I appointed a task force of the Federal Home Loan Bank presidents to develop a plan to recapitalize the fund, utilizing available financial resources of the Federal Home Loan Bank System and the industry, in combination. What emerged then still constitutes the basic outlines of the Bank Board-Treasury recapitalization plan which was first presented to the Subcommittee on Financial Institutions on May 8, 1986. The plan, in different forms, passed both Houses of the Congress in the last days of the 99th Congress. However, final action was delayed. On January 6 of this year, the Chairman of this Committee and Congressman Wylie jointly introduced H.R.27. This bill incorporates the same basic FSLIC recapitalization framework approved by both the Senate and the House last year.

The Bank Board-Treasury plan is intended to provide sufficient resources over the next five to seven years to resolve the terminally-ill thrift cases which we know about or can reasonably expect over that period.

Last Spring, I estimated the cost of resolving known cases requiring FSLIC assistance to be in the neighborhood of $16 billion. A good deal of work has gone into a revision of last year's estimate and we now put the known cost at $19.5 billion. There are borderline cases, however, which I want to add to this estimate which would bring the total to $23.5 billion.

I must emphasize that these are estimates. No one can know with certainty in advance what the actual cost of resolution to the FSLIC will be over time. But I am comfortable that these are good faith estimates based on very considerable relevant supervisory and financial data. Clearly a significant rise in interest rates, or other unforeseen economic circumstances in the future, could affect any current estimate.

The overall plan to recapitalize the thrift insurance fund which we have proposed contemplates -- if necessary -- as much as $32.5 billion for resolving terminally-ill thrift cases over the next seven years. Thus, the plan provides another $9 billion to deal with additional, now unknown contingencies, if they develop, above and beyond the estimated $23.5 billion which could possibly be needed to resolve cases, as described above. How the plan works is summarized in Section II (page 13) of this statement.

In focusing on the recapitalization issue, it seems to me we also should focus on the future of the thrift industry, itself, and the statutory system which the Congress has put in place to both govern its public purpose, consistent with the intent of law, and to regulate for safety and soundness, pursuant to statute and regulatory standards.

Replete within the body of federal law enacted over the years is the clear and unmistakeable message that the thrift system exists to serve a public policy purpose -- a purpose which is significantly different from that which governs the commercial banking system. The clear public policy purpose for the thrift system, as set forth in statute, is to serve the <u>principal</u> public policy goal of financing housing and homeownership. This is, by no means, the sole reason for the separate existence of the thrift system but it is -- pursuant to the intent of law -- the principal reason. If it were not, and if thrifts were intended to play the same identical role as commercial banks, then there would be little apparent reason for the maintenance of a separate and distinct statutory-based thrift system.

The Congress devised, and has continuously supported the idea behind the separate existence of the thrift system for more than a half century, evidently because it has believed that relatively specialized financial institutions with a particular expertise in housing finance serve to effectively support the public policy goal of maximizing homeownership opportunities for American families.

Indeed, at the end of 1986, thrift institutions held in their portfolios more than half the residential mortgage debt in the country, or nearly three quarters of a trillion dollars.

Thirty percent of the nation's mortgage backed securities were not held by private investors, pension funds, insurance companies, etc., but, by thrifts, to the the tune of $156 billion at the end of 1986. During 1986, insured thrift institutions originated half of the home mortgages in the country, compared to 19 percent by commercial banks.

To facilitate the purposes of the thrift system, the Congress created a separate central banking structure for thrift institutions in the form of the 12 regional Federal Home Loan Banks. These government-sponsored instrumentalities of public policy lend funds ("make advances") of varying maturities, including long-term funds, to thrift institutions at attractive rates. The Federal Home Loan Banks also fully pay the costs of the front-line regulatory system, namely examination and supervision, for the purpose of assuring compliance with statutes and regulations -- including insurance regulations which are intended to safeguard the resources of the thrift deposit insurance fund. Notably, this insurance fund was established by the Congress under the authority of the National Housing Act.

In 1982, the Garn-St Germain Act consisted, in significant part, of amendments to the Homeowners Loan Act of 1933. My own understanding of the intent of the Garn-St Germain Act is that it was intended to maintain the essential traditional public policy purpose of the thrift system, that of principally serving America's housing finance needs. In order to do this, the Congress felt that thrift institutions ought to have significantly more bank-like lending and operating flexibility to more effectively support their basic, or principal mission, of providing funds for residential housing finance. Some states have gone well beyond what Congress appears to have intended in this regard by providing their own state-chartered thrifts far more expansive lending, investment and operating authorities.

Still, the body of law enacted by the Congress up to now for the thrift system is clear in its emphasis on housing finance as the principal public policy justification for the continued existence of a separate and distinct statutory thrift system. Some may not agree with that emphasis but, in my mind, that seems to be the intent of Congress in the statutes -- which I am sworn to uphold and carry out.

Some in the financial community argue that the thrift system has outlived its usefulness, that it is obsolete in the emerging financial services environment, and that the thrift deposit-insurance fund ought to be "merged" with the FDIC fund.

They recognize, as you must, that a so-called "merger of the funds" would signal the beginning of the end of the thrift industry and the statutory thrift system, and in my opinion, they are basically correct in this regard.

Those who talk of "merging" the thrift and commercial bank deposit insurance funds surely cannot expect to be taken literally. I do not believe there is any chance, whatsoever, that the Congress would seriously consider "merging," that is to say "comingling" or "integrating" resources of both funds into a single deposit insurance fund at any time in the foreseeable future because such a comingling of the dollars available in one fund is simply not politically feasible.

In "merging " -- yes, "comingling" -- the finances of both insurance funds into one, under the governance of the FDIC, such a pooling of finances would be called upon to pay for both thrift and commercial bank failures. Again, I do not believe this is politically feasible. Beyond the political consideration, such a merger would only serve to weaken the resulting, integrated and comingled common deposit insurance fund because its obligations to pay for losses would be far greater, without a commensurate increase in its reserves.

Those who talk of a "merger of the funds" surely must really be talking about a transfer of the current governance of the thrift deposit insurance fund from the Federal Home Loan Bank Board to the Board of Directors of the FDIC. Were this to be the case, it would not constitute a "merger of the funds" at all, but rather a consolidation of the governance and management of two separate deposit insurance funds under one board of governors. And, if this were the case, recapitalization of the thrift fund would still be necessary in order for the new management of the thrift fund, namely the board of governors of the FDIC, to resolve thrift failures and meet obligations to thrift depositors.

The issue of which board of governors should oversee and manage the thrift fund does indeed have profound, historic implications for the future of the thrift system, as I suggested earlier. The FDIC, which serves as the deposit insurance arm of the commercial banking regulatory apparatus, and which exercises author ty over some 14,000 commercial banks in this country, is oriented toward an industry which generally is quite different from the more specialized nature of the thrift industry. This suggests, to me at least, that such an orientation, if the FDIC were to govern both insurance funds, would subsequently lead to a consolidation of the thrift regulatory and credit (Federal Home Loan Bank) apparatus w th that is to say, into -- the commercial banking system apparatus Thus, if my instincts are correct, the consolidation of governance of both deposit insurance funds under the FDIC would not merely represent a "change of control" over the thrift insurance fund but would definitely signal a profound change in direction for the depository institutions system in this country -- namely that any statutorily-based system primarily oriented toward specialization in home mortgage finance might well be seen as significantly less relevant to meeting public needs in the future.

The Congress could, of course, establish a new and different public policy rationale to justify the continued existence of a separate "thrift" system, but that too might well signal a major departure from its longstanding support for a rather more specialized housing finance system within the overall depository institutions structure of the nation's financial system.

Whether the Congress chooses, at any time, to consolidate governance of the two deposit insurance funds under the FDIC is a call the Congress and the President will have to make. I hope the recapitalization issue doesn't get us to that point, but rather that our recapitalization plan moves us in the opposite direction.

Regardless of how that comes out, recapitalization of the thrift deposit insurance fund is, and will be, necessary in any event. In my view, the Bank Board-Treasury plan -- though not perfect, but what is? -- is far superior to any other plan of which I am aware.

I believe very deeply that recapitalization of the thrift insurance fund requires a commitment -- that is to say, deep resolve on the part of regulators and leaders in the Congress to assure that effective measures are put in place to halt future hemorrhages, resulting from new cases, in order to give recapitalization the best chance to succeed. Indeed, without such future resolve and commitment, the likelihood of such success is at the very least questionable.

What is really called for, in this regard, is courage.

Regulatory initiatives to assure safety and soundness are often controversial in the thrift industry. Some members of the Congress sometimes bring substantial pressure to bear on regulators to relax or even withdraw regulatory initiatives intended to strengthen safety and soundness in the industry. In my opinion, what they ought to be saying to us is: "You take the heat. We'll back you up. Do what you have to do to make the system work."

It seems to me that any commitment to recapitalize the thrift insurance fund by the Congress, itself, does, indeed, require a corollary commitment to maintain the viability of the plan by maintaining the true integrity of the regulatory process. During my tenure in office, most of the regulatory actions taken by the Bank Board, in its role as operating head of the thrift insurance fund, have been intended to promote safe and sound and prudent thrift operating practices, and thus reduce the risk of loss, as well as actual losses, to the insurance fund.

When thrift deregulation, on both the asset and deposit side, went into effect a few years ago, the regulatory apparatus n the Federal Home Loan Bank System was simply unprepared to effectively manage the new risks deregulation brought with it. In the face of considerable obstacles over time, the Board has nevertheless made considerable progress in overhauling and modernizing the regulatory apparatus to better assure that safe and sound operating practices are observed in the industry. The Board has taken positive, forward steps to move the industry toward common accounting and capital standards with the commercial banking sector. But more remains to be accomplished.

Throughout my tenure, I have worked hard to implement important reforms to encourage continued safe and sound operation in the deregulated thrift environment. One of the most important accomplishments of the Board has been the strengthening of the oversight function, namely examination and supervision. Today, we have over 1,500 field examiners throughout our system. That is twice as many as we had just a year and a half ago. In little more than two years, we have tripled the size of our professional supervisory staff throughout the 12 Federal Home Loan Bank ("FHLBank") districts.

I also have strongly advocated higher thrift capital standards that move us strongly in the direction of commercial bank requirements. Last August, the Board adopted a new capital rule that requires all FSLIC-insured thrifts to increase their

net worth to the six percent range over a phase-in period tied to industry profitability. The new rule also incorporates a risk-based formula. Thrifts must post added capital for riskier investments such as acquisition and development loans. Similarly, the rule permits reductions based on effective interest-rate risk management.

The Board has also moved significantly in the direction of requiring institutions to report to us using generally accepted accounting principles. In 1984, we did away with loan loss deferrals for accounting purposes on a prospective basis. Five-year averaging and twenty-year phase-in of regulatory capital are gone. Further appraised equity capital treatment for thrift offices and branches has expired.

We are moving quickly to improve the FSLIC's ability to use the funds that recapitalization could provide. Last year we initiated an in-depth review of our FSLIC case resolution and receivership operations. Based on the findings of that review, I have charged a system-wide Task Force to present recommendations and implementation plans to the full Board within the coming month. The Task Force has been asked for:

-- Implementation procedures to support a recommendation for delegation to the regional Federal Home Loan Banks of the staffing for FSLIC case resolutions;

-- Implementation procedures to support a recommendation for stronger Board oversight of FSLIC receiverships; and, the fullest possible use of the Federal Asset Disposition Association (FADA) for both FSLIC asset analysis, and the management and disposition of receivership assets;

-- Implementation procedures to support a recommendation for a complete restructuring of the case resolution process to provide more timely due diligence reports, earlier decision-making by the Board, and a revamped national marketing program;

-- Implementation procedures to support a recommendation for the creation of regional counsels at the Federal Home Loan Banks to provide legal support for local Bank case resolution staff work;

-- Implementation plans to support a recommendation for the creation of new budget, case planning, cash management, and audit review procedures for FSLIC. The evaluation of FSLIC staff performance and bids for the acquisition of institutions will now be judged under a

completely revised system which capitalizes the holding cost of assets in determining benchmarks for adequate recovery of value;

-- Implementation procedures for a new management information system ncluding regular and exception reporting to support broader Board delegation of FSLIC functions. This recommendation will require the development of standardized FSLIC procedures for the bid valuation process for due diligence reports, for all case analysis, for bid package preparation, and for post-audit reviews.

We expect to start the process of implementing these reforms within 60 days. I am confident that the proposals I have just described will permit the Board to give timely and accurate reports to the Congress of our disposition of FSLIC funds. I further expect that these reforms of the FSLIC case resolution and receivership procedures will insure the maximum recovery of value for the FSLIC fund by using fully the regional resources of the Federal Home Loan Banks, the organizational expertise of FADA, and focusing the work of our FSLIC central staff on case planning and budgeting, policy oversight and post-audit review.

In my role as regulator, I have not pandered to the industry, and most particularly to the high risktakers, the high rollers and daredevils, who through their greed and lack of prudence in operating federally-insured savings institutions have created huge losses, and prospective losses, for the thrift insurance fund. On the contrary, I have sought, with some considerable opposition at times, to put in place rules which I have believed would lessen the risk of loss to the insurance fund, without unduly restricting sound opportunities for thrift institution profitability. In part III of this statement I address one important example of such a rule, the direct investment rule.

At a time when we are talking about the state of affairs which has brought us to the critical issue of FSLIC recapitalization, this is no time to temporize on the direct investment issue. In my mind, the recapitalization of the thrift fund makes little sense if we fail to deal with the direct investment issue and its impact on the reserves of the FSLIC.

The effort I have undertaken over time to restore discipline and safety and soundness principles to the thrift system must continue. Call it "re-regulation" if one feels compelled to do so, but there is simply no substitute -- by whatever name -- for safety and soundness if recapitalization of

the thrift insurance fund is to be effective in both the short and long term. Without appropriate discipline in the thrift industry, and a recognition on the part of everyone that safe and sound thrift operations are the key to the thrift industry's future, any plan to recapitalize the thrift insurance fund can only end in ultimate failure. A hemorrhage of losses to the thrift fund from a spate of new thrift failures (above and beyond anticipated resolution costs) arising from a failure to insist on, and yes demand, that thrift managements operate their institutions safely and soundly and prudently, would be a self-defeating phenomenon.

Hence the need for greater regulatory discipline, to assure that safe and sound thrift operating practices do prevail in the future, and a strong realization on everyone's part that protecting the future reserves of the fund is, in the deepest sense, truly in the public interest, because it is the taxpayers of this country who ultimately stand behind the thrift deposit insurance fund.

II. THE FHLBB-TREASURY PLAN TO RECAPITALIZE THE FSLIC

The crux of the proposal has not changed from that outlined in early 1986. It allows the use of the retained earnings of the FHLBanks to serve as seed money for a new government corporation (the "Financing Corporation"), which would leverage the seed money to borrow from $10 to $15 billion over the next few years. The Financing Corporation would then use these funds to purchase stock in the FSLIC We estimate that, over the next five to seven years, the FSLIC would obtain capital of from $25 to as much as $32.5 billion from its sale of stock to the Financing Corporation, premium collections, income from the disposition of assets under receivership, and income from its investments.

During the next five to seven years, the FHLBanks would contribute to the Financing Corporation as much as $3 billion of their retained earnings. The FHLBanks' retained earnings, as of December 31, 1986, aggregate in excess of $2 billion. Even assuming slow economic growth, within five years or so these retained earnings are expected to grow to approximately $3 billion.

The Financing Corporation would operate in two concurrent modes -- as a funding corporation and in a sense, as a trust. It would have all the same attributes as a government agency operating in the capital markets. That is, it would be deemed a safe, high quality security utilized for a high public purpose and thus eligible for purchase by various trusts and fiduciaries. However, its debt would have no guarantees from the Treasury or the FSLIC. Further, it would have no paid staff of its own, but would utilize the existing staff resources of the FHLBank System. The Financing Corporation would sunset by 2027.

The Financing Corporation's borrowings would take the form of collateralized long-term bonds. It could access the capital markets, as the FSLIC's needs dictated, over the next five to seven years. For example, f the FSLIC's resolution costs over that period were less than the roughly $23.5 billion we anticipate, the Financing Corporation would simply use fewer FHLBank retained earnings as seed money for borrowing in the capital markets. This flexibility allows the plan to deal with resolution costs on an "as necessary" basis.

Payment of the principal and interest on the bonds would be the sole obligation of the Financing Corporation. Importantly, no payment would be guaranteed by the U.S. government. Payment of the principal amount of the bonds would be assured, because the principal would be fully collateralized at maturity with government securities held in trust for that purpose. The

Financing Corporation would purchase this collateral with a portion of the funds it receives from the FHLBanks. Over 25 to 30 years, the term of the bonds, continuing return on the collateral would compound enough interest to assure payment of the principal amount of the bonds. Such investment returns are most easily assured by the purchase of zero coupon bonds, but other means are also available.

Investors also could reasonably expect prompt payment of interest on the bonds of the Financing Corporation. Interest would be paid with funds from two sources: (1) a reserve funded with a portion of the funds contributed by the FHLBanks and (2) dedication of a portion of the FSLIC premium stream from insured institutions. To prevent a "double whammy" to insured institutions the bill reduces FSLIC's premium assessment authority by any debt service the Financing Corporation incurs.

Advantages of the Proposal

The proposed bill produces several important benefits. First, the FSLIC would be able to employ as much as $32.5 billion over seven years -- if necessary -- to resolve its case load of terminally-ill thrifts. This would halt expansion of the FSLIC's problems and boost depositor confidence n the FSLIC, the thrift system and the overall financial system. Most important, the taxpayers would not spend a penny for the cost of recapitalization. The cost would be borne solely by the FHLBanks and FSLIC-insured thrifts without any government guarantee of Financing Corporation debt. Third, the flexibility built into the bill permits the Board to raise gradually a range of funds for the FSLIC -- as needed to resolve cases involving terminally-ill thrifts. Additionally, the bill is structured carefully to create budgetary receipts from the equity investments in the FSLIC that will offset budgetary outlays resulting from the FSLIC's case resolution costs.

From the industry's perspective, renewed public confidence plus the sale, merger, or liquidation of the weakest thrifts should help the industry lower its cost of funds. The cost differential that thrift institut ons pay over that of commercial banks is in excess of $4 billion a year. In addition, the bill provides for the FSLIC recapitalization burden to be shared fairly between the thrifts and the FHLBanks, with contributions structured to minimize the adverse effects on both. It must be kept in mind that the FHLBanks will still be able to economically provide long-term funds to many of the smaller thrifts which cannot access these markets themselves.

Ability of the FHLBanks to Provide Seed Money

The FHLBanks, whose stock is wholly owned by member savings institutions, derive their income from the advances and other services provided to their member savings institutions. In 1986,

the FHLBanks earned $1.4 billion and paid out over $900 million dollars in cash and stock dividends. At December 31, 1986, the FHLBank System had an aggregate of $131 billion in assets and $11.7 billion in capital with total retained earnings of $2.3 billion; making it one of the strongest financial entities in the world.

Given the level of retained earnings and income, we expect that the FHLBanks could provide $3 billion to the Financing Corporation over the next several years. This amount, in relation to its extremely strong capital base, insures that FHLBank debt would be protected from possible higher borrowing spreads.

Phase-Out of Special Assessment

Finally, the industry will benefit because the recapitalization funding will permit the FSLIC to phase out its special (premium assessment Under our current assumptions, the special assessment could be phased out gradually over five years. We believe such a phase-out of the special assessment provides the many healthy institutions an opportunity to see "a light at the end of the tunnel" with respect to that costly, but now necessary, burden.

Exit Fees

In short, I believe that this plan represents the most feasible and cost-conscious method to assure the continued strength of both the FSLIC and the thrift industry. No responsible person, however, can ignore the fact that the plan's ultimate viability depends on reliable revenue projections. The plan can work over its projected life only if we take into strong account now the need to maintain a growing deposit base in the industry to support FSLIC's activities. However, some members of the industry have threatened to change their charters and abandon the FSLIC insurance system, thus avoiding the payment of FSLIC insurance premiums.

To avoid any doubts that might undercut the plan's overall design or investor confidence, I believe the best approach is to devise an express statutory safeguard to limit erosion of the FSLIC-insurance premium-paying base. The National Housing Act currently authorizes the FSLIC to charge a fee against institutions that voluntarily leave the FSLIC insurance system. As you know, the FSLIC has been assessing "exit fees," but recent litigation may have a chilling effect on the flexibility I believe the FSLIC urgently needs. I propose that the bill under consideration be rev sed to reaffirm and expand the authority of the FSLIC to impose fair and reasonable "exit fees." In my view, adopting appropriate language to reaffirm our authority in this regard is crucial to maximize the long-term success of recapitalization.

It is our view that such exit fees should not impose an insurmountable barrier to those who may choose to leave the FSLIC for this or other legitimate business purposes. However, the exit fee must roughly cover in present value terms the lost premium stream over the early years of our plan, when it is more vulnerable. Some of our exit fees to date have been designed with these dual objectives in mind. We will soon provide you with a proposed amendment to the bill to address this problem.

<u>Risks</u>

Finally, I cannot overstate the urgent need to adopt the recapitalization plan as soon as possible. Waiting six months or more could fatally harm our plan by eroding consumer and investor confidence and further imperiling the FSLIC. To summarize these risks:

- The major risk of delayed passage is that it would jeopardize the guaranteed advances program of the FSLIC and could precipitate a liquidity crisis or drive up the cost of retail deposits. As previously mentioned the FHLBanks have made roughly $3.6 billion in advances to thrifts that are FSLIC cases, on condition that the FSLIC guarantee these loans. Another $2 billion in such advances has been requested at this time. If these advances were not made and some of the outstanding $3.6 b llion not renewed, it would require the institutions to compete aggressively for what are clearly high cost retail deposits, thereby increasing costs for themselves and other institutions in their markets. Some institutions would be forced to seek emergency funds directly from the FSLIC, placing a greater strain on the slim primary reserves of the FSLIC.

- The ongoing operating costs of failing thrifts that the FSLIC cannot afford to close is mounting by over $6 million a day or almost $2.2 billion a year. We are hardly even able to "tread water" if we don't close costly and terminally-ill cases as soon as we can.

- Further delay may well jeopardize the ability of the recapitalization plan to go forward. The plan can succeed only if capital market funds are obtained at a reasonable cost. Investor concerns about the continued weak state of the FSLIC and the abil ty of Congress to deal with it could undermine confidence to the po nt where such bonds would be very costly. If such uncertainity rises to this point the plan could become infeasible for two reasons: (1) debt service could exceed premium income or (2) the investor base could shrink as those constrained to high quality investments withdraw. This would prevent raising sufficient funds for resolving cases.

- Finally, delay would sharply increase costs due to the loss of certain tax provisions that now reduce FSLIC costs, as such provision are scheduled to expire December 31, 1988.

III. <u>DIRECT INVESTMENT</u>

As I emphasized earlier, recapitalization is not a panacea but simply the first step to restoring the FSLIC to long-term viability. In my own personal view, an important regulatory adjunct to recapitalization is the direct investment rule.

The regulation in place now, which was adopted by the Board nearly two years ago, uses the concept of a supervisory review threshold beyond which state-chartered FSLIC-insured thrift institutions must obtain supervisory approval to exceed the threshold. The threshold is ten percent of assets or twice net worth, whichever is greater.

In December, a majority of the Board voted to extend the rule's sunset date to March 15, 1987, to hold a public hearing on January 29 and 30, and to seek additional comments. The views I express here are my own, and reflect my understanding of the facts at this time. I will, of course, consider any new facts presented in the comments or at the hearing before I cast my vote on the rule.

The few vociferous opponents of the rule constantly misrepresent what the rule requires. I would like to explain what the current rule is. The rule does not prohibit a thrift from making direct investments. State-chartered thrifts meeting their minimum net worth requirements may place up to ten percent of their assets or twice their net worth, whichever is greater, in direct nvestments allowed under state law without seeking any approval from the FSLIC. As I will explain in more detail, this is an extraordinarily generous level of direct investment that far exceeds what you in Congress have decided is appropriate for federally-chartered thrifts and what our sister banking regulators have proposed for commercial banks. All our rule does is establish a threshold beyond which FSLIC is allowed the opportunity to determine whether the thrift lacks adequate managerial resources, business plans, or diversification to make direct investments beyond threshold levels in a safe and sound manner. FSLIC bears the ultimate risk of loss on such direct nvestments because it insures these state-chartered thrifts. The threshold allows the FSLIC a modest ability to limit its risk exposure before it is too late.

The rule was carefully designed to minimize regulatory burdens, to avoid regulation to the lowest common denominator and to consider the view of state regulators. First, the regulation effectively creates a presumption of approval. An

application to exceed the threshold must be approved unless the Principal Supervisory Agent ("PSA") can make one or more of four specified findings indicating excessive risk.

Second, speedy processing of applications is assured. A complete application is "deemed approved" unless the PSA makes one of the four findings and denies it within 30 days.

Third, the application requirements are minimal. The application principally requires a business plan that demonstrates that the thrift has managerial resources with expertise in the planned areas of direct investment, sound underwriting practices and intends to diversify its investments. I must admit that I am stunned when opponents of the rule complain of the necessity to prepare a business plan prior to making huge direct investments of a magnitude that would exceed the threshold. The fact that they would embark on such a risky course without a business plan reveals precisely why the FSLIC badly needs protection from such gamblers.

Fourth, the application to exceed the threshold need not set forth the specific direct investments contemplated. Opponents of the rule have complained that business deals have short fuses, and that even though a complete application is "deemed approved" after 30 days, they will lose some deals if they have to apply to make each individual direct investment beyond the threshold. This criticism might have some validity if the rule imposed such a requirement. It does not. The rule expressly authorizes applications for authority to go to some level of direct investment, e.g. 20 percent of assets. Such an application can be filed in advance and, if not denied, will allow immediate consummation of future direct investment deals.

Fifth, the rule provides an important role for state regulators. If the state regulator supports the application, the PSA must confer with that regulator and consider his or her views in evaluating the application. In the event that the PSA disagrees with the state regulator, the application is automatically referred to the Bank Board for decision.

Sixth, there is a right of appeal to the Bank Board if the PSA denies the application. Once again, if the Bank Board does not affirm the PSA's denial of the application within 30 days of the Bank Board's receipt of the appeal, the application is "deemed approved." Even if the Bank Board affirms the denial, the thrift can obtain judicial review of the Bank Board's decision.

Seventh, the rule clearly does not regulate to the lowest common denominator. Thrifts that do not meet their net worth requirement cannot make direct investments without prior PSA approval. Stronger thrifts can invest up to the threshold without any necessity of seeking approval. The fact that the

rule sets the threshold at the greater of ten percent of assets or twice net worth also favors stronger thrifts. While FSLIC is in a severe financial crisis, we should not forget that most of the thrift industry is healthy and profitable. Any state-chartered thrift with net worth above five percent has a threshold in excess of ten percent of assets. Fifty-eight percent of all state-chartered thrifts have net worth in excess of five percent. Equally important, thrifts with strong net worth and management are those most likely to receive approval to exceed the threshold.

I hope you will agree with me, that your sister committee on Government Operations was right when it praised the rule for its flexibility and suggested it as a model for other financial regulatory efforts.

The rule was not only carefully designed; it's working. As we thought, the thresholds were set at such a generous level that only a tiny percentage of thrifts have sought to exceed them. Indeed, even those state-chartered thrifts which could exceed the ten percent of assets prong of the threshold without any application, because they have net worth in excess of five percent, rarely do so. For example, of 73 institutions (54 of which are state-chartered) in California with tangible net worth greater than six percent only eight thrifts placed more than ten percent of their assets in direct investments. For Texas, only three of 54 thrifts (38 which are state-chartered) with tangible net worth greater than six percent placed more than ten percent of their assets in direct investments. While federally-chartered thrifts cannot make such large direct investments, it is relatively easy to convert from a federal to a state charter. Because the threshold allows a thrift to invest twice its regulatory net worth, which is invariably greater, and often much greater, than tangible net worth, each of these 127 thrifts could have invested at least 12 percent of its assets in direct investments without filing any direct investment application with the FSA. It is clear that the vast majority of thrifts do not find it prudent to invest such high proportions of their assets in riskier direct investments. Moreover, as I explained earlier, the extra expense of filing an application should be minimal, because the only time-consuming requirement, preparing a business plan, would be done by any prudent thrift, even in the absence of a regulatory requirement. If direct investments were believed to produce substantial profits safely, the minimal extra cost of providing the other data required in the application plainly would not deter any filings.

The latest complete data I have show that through September 30, 1986, only 74 applications had been filed to exceed the threshold. Twelve of those applications were withdrawn. Thirty-seven were approved. Ten were denied. Four of those denials were to the same two institutions. Fifteen applications

were pending. Thus, over 50 percent of all applications which had been decided had been approved. The system is working extremely well. It works expeditiously, with minimal regulatory burdens on the industry, and the PSAs are differentiating between thrifts on grounds for which there is broad agreement. Indeed, the denials have not proved controversial. Only one has been appealed to the Bank Board. No one has sued.

Everyone knows the rule is very controversial, but in fact, it has been close to devoid of controversy. There is the most amazing propaganda campaign opposing this rule that I have ever seen. The rhetoric and tactics used have been vituperative, but they are the product of a minuscule number of thrifts.

I mentioned earlier that the rule's thresholds are generous in comparison to those set by Congress and the banking regulators. Congress has set the levels of direct investments it considers prudent for federally-chartered thrifts. That level is three percent of assets, and it is a flat limit on direct investment, not a threshold that can be exceeded absent denial by the PSA. In my experience, Congress always carefully considers the impact of thrift investment authority on the health of the FSLIC fund because of its concern for the fund and because of the potential impact on the Treasury of any collapse of the fund. State legislatures have no financial stake in the laws they pass authorizing direct investments by FSLIC-insured thrifts. Frankly, some states do not seem to have given careful consideration to the impact on the FSLIC fund of the extraordinary direct investment authority they have granted to thrifts they charter but FSLIC insures.

The banking regulators have proposed far more stringent limitations on direct investments. The Federal Reserve Board's ("FRB") proposal would require such direct investments to be made through service corporations and limit a national bank's equity investment in the service corporation to no more than five percent of the bank's primary capital. Contrast this proposal with our threshold which allows a thrift to invest twice its regulatory net worth, i.e., 200 percent of net worth, in direct investments without making any application. That is 40 times greater than the FRB's proposal, but that comparison is misleading. Much of what a thrift can count as regulatory net worth (e.g., subordinated debt and goodwill) is not eligible for treatment as primary capital. Indeed, half of all regulatory net worth is goodwill. Thus, our threshold is approximately 80 times greater than the FRB's proposal. Another way to analyze the situation is to consider a thrift with three percent net worth. It can place ten percent of its assets (333 percent of net worth) in direct investments before triggering the threshold. The threshold for such an institution is over 65 times greater than under the FRB's proposal. Indeed, the FRB probably would not allow a bank with such low capital to make

any direct investments (or even stay in business). And remember, our threshold is simply the point at which the FSA gets a chance to review an application.

The FDIC proposal is more generous than the FRB's, but still much more stringent than our rule. It would allow a bank to invest up to one-half its primary capital in direct investments. Our net worth threshold is four times greater than that (generally over eight times greater when the difference between regulatory net worth and bank primary capital is considered). Our ten percent of assets threshold, for a thrift with three percent regulatory net worth, would again be 333 percent of net worth or over six times greater than for a bank under the FDIC's proposal. Once more, the few shrill opponents of the rule have tried to picture the Bank Board as out-of-step with Congress and banking regulators. As my explanation shows, if we are out-of-step it can only be because we are far too restrained in our regulation of direct investments.

The final area of dispute on direct investments is their relative risk. This is one of those rare areas where common sense, economic theory and actual results agree with each other. Common sense tells us it is better to be a secured creditor of a bankrupt company than a stockholder in it. Secured creditors take first, equity investors recover only if there is enough money to pay all the creditors in full. Common sense tells me that if someone is offering me a higher expected rate of return on a direct investment than a mortgage loan he is doing it for a reason, not because he is generous. The reason he has to offer me a higher expected rate of return is bacause I take on more risk if I make the direct investment than if I make the home mortgage loan Economic theory says the same thing -- direct investments are generally riskier and therefore carry a higher expected rate of return.

Our supervisory experience agrees with common sense and economic theory. FSLIC has suffered terrible losses from direct investments and purported loans that were really direct investments.

We have done a study of our losses from direct investments in recent failures. In a June, 1986 study by James R. Barth, R. Dan Brumbaugh, Jr. and Daniel Sauerhaft, titled "Failure Costs of Government Regulated Financial Firms: The Case of Thrift Institutions," the authors of the study concluded that for failed thrift institutions, each dollar of direct investment increases the cost to FSLIC by 60 to 85 cents.

Also, I recently asked my staff to review the status of thrift institutions surveyed in a 1984 study prepared by Dr. George Benston. In that study, Professor Benston argued against any restrictions whatsoever on direct equity investments. In my opinion, the results of this update provide further justification for the proposed extension of the regulation.

In his original study, Dr. Benston picked a sample of 34 of 37 FSLIC-insured institutions which had direct investments in excess of ten percent of assets in December 1983. In 1983, the average regulatory net worth of these 37 nstitutions, as a percentage of liabilities, was 4.3 percent as compared to the thrift industry's average net worth, of 4.18 percent in December, 1983. On the basis of this comparison, Dr. Benston claimed that direct investments posed no additional risk. By June 30, 1986, that ratio for the 37 institutions had dropped from 4.3 percent to 0.23 percent while the industry average had risen to 4.66 percent on June 30, 1986.

Of the 37 institutions, 21 have since either been closed, or are insolvent, or are projected to be insolvent within a year.

Ten of the 21 institutions are in the FSLIC caseload today. They have assets of $6.3 billion and the projected losses to the FSLIC through resolution is $2 billion.

Eight of the 21 cases are projected to be insolvent within a year. They have assets of $3.75 billion and we estimate the cost to the FSLIC of resolving them is $1.2 billion.

Three of the 21 institutions have been closed. They had assets of $730 million. Estimated cost of resolution to the FSLIC: $350 million.

The other 16 (of the 37 institutions) had a return on assets of 30 basis points on June 30, 1986 -- far below the average return on assets of the profitable four-fifths of the thrift industry, 103 basis points, on the same date.

The 21 institutions I have described above have cost, or are expected to cost, the FSLIC about $3.5 billion to resolve -- over $1.5 billion dollars more than the total primary reserve of the FSLIC today -- and, again for just 21 failed or failing institutions.

The 37 institutions, which had in excess of ten percent of assets in direct investments in December, 1983, and which had an average regulatory net worth of 4.18 percent, now are down to 0.23 percent -- an average verging on insolvency. In sum, the very sample chosen by Dr. Benston as an important basis for his

claim that direct investments beyond the thresholds reduced risk and increased profits has provided devastating evidence of the errors of his analysis.

The Bank Board staff has done another study along the same lines, but has limited it to the California experience. California, as you know, has the most liberal law for state-chartered thrift institutions in the country, with the authority granted to its own charters to place up to 100 percent of assets in direct equity investments.

The study shows that 33 California state-chartered thrifts, insured by the FSLIC, had direct investments in excess of five percent in December, 1983. In September, 1986, 27 of these institutions were left. Five had failed. One had merged.

The average regulatory net worth, as a percentage of liabilities, for the 33 California thrifts was 3.08 percent in December, 1983. They had an average return on assets of 0.066 percent.

By September, 1986, the 27 California institutions which remained had an average negative net worth of 0.304 percent and an average negative return on assets of 3.345 percent. Eight of the 27 institutions are projected to be insolvent within a year, seven are FSLIC insolvencies and five have failed. These 20 institutions in California are expected to cause losses to the FSLIC amounting to $3.15 billion.

Of 13 California institutions which had on their books in excess of ten percent of assets in direct investments in December, 1983, eleven remain. In December, 1983, these 13 institutions reported regulatory net worth of 2.771 percent and a negative return on assets of 0.172 percent. By September, 1986, the eleven institutions which remained were reporting average negative net worth of 9.692 percent and an average negative return on assets of 12.691 percent.

Three of the eleven institutions are projected to be insolvent within a year, five are FSLIC insolvencies and two have failed. These ten California institutions are projected to result in losses to the FSLIC of an estimated $1.9 billion.

To put this in perspective, by comparing the performance of the California thrift institutions which were not, and are not, making direct investments above five percent of assets (148 institutions in December, 1983), these institutions had an average net worth of 4.698 percent and an average return on assets of 0.486 percent in December, 1983. By September, 1986, these institutions had increased their average net worth to 5.350, and their average return on assets had nearly doubled to 0.854 percent.

Reviewing these studies, I see some very significant trends. First, the studies seem to show that a thrift does not have to engage in high levels of direct investment to be profitable.

Second, they demonstrate very clearly that an institution can lose its shirt if it's not very careful in making direct investments.

Third, these studies show that the FSLIC can suffer large losses. The estimated losses, simply from the 20 California institutions I just described, far exceeds the FSLIC's primary reserve.

Fourth, the existing thresholds may be too high. The study of California thrifts with more that five percent of their assets in direct investments reveals that they have fared much worse than thrifts with lower levels of direct investment. The ten percent of assets threshold may be too high.

I certainly am not arguing that the studies demonstrate that direct investment automatically cause failures. But these trends do suggest to me that a supervisory review process is justified when an institution wishes to exceed the ten-percent-of assets threshold in direct investments. And that review process, in my opinion, is a minimal cost when weighed against the risk of subverting the full recovery of the industry and the FSLIC by inviting similar enormous losses in the future.

After a lengthy study by the House Government Operations Committee on the Bank Board's Direct Investment Regulation in 1985, the Committee concluded that the rule was "a prudent precaution while the FSLIC is in a weakened condition." The Committee did not have the benefit of the studies I have just highlighted when they reached this conclusion.

No one can possibly disagree that the fund remains in a weakened condition, even more so than when the Committee report was prepared in 1985. Indeed, the FSLIC's primary reserves have declined by 42 percent since 1985, to $1.9 billion today. And those reserves stand behind more than $800 billion in deposits.

I would hate to see a commitment to recapitalization of the thrift insurance fund without a concurrent commitment to the safety and soundness principles this regulation seeks to address. In the absence of appropriate extension of this rule by the Bank Board, I request that, at a minimum, the language of the rule be included in any legislation to recapitalize the thrift insurance fund.

At a time when we are talking about the state of affairs which has brought us to the critical issue of FSLIC recapitalization, this is no time to temporize on the direct investment issue. In my mind, the recapitalization of the thrift fund makes little sense if we fail to deal with the direct investment issue and its impact on the reserves of the FSLIC.

IV. THE FEDERAL ASSET DISPOSITION ASSOCIATION

Section 7 of H.R.27 subjects the Federal Asset Disposition Association (FADA) to the requirements of title 31 of the United States code defining FADA as a mixed-ownership government corporation, requiring GAO audit, and to the provisions of section 552B of title 5 of the United States code relating to the "Sunshine Act". In addition, Section 7 would require FADA to report directly to the House and Senate Banking Committees with respect to a specific list of information.

By way of background, FADA is a Federal Savings and Loan Association chartered under the provisions of section 406 of the National Housing Act. All of its stock is owned by FSLIC, which has capitalized it with $26,000,000, and has arranged a $50,000,000 operating line of credit for it with the Federal Home Loan Bank of Topeka. FADA's mission is to assist the Bank Board and the FSLIC in dealing with troubled real estate assets. It is specifically prohibited by its bylaws from taking title to any of those assets and is also not allowed to borrow any money in the capital markets unless those borrowings are made by, or approved by, the FSLIC.

The full implications of Section 7 of the bill for FADA's operations are not clear. The Bank Board and FADA are studying those implications. At this time, I can say that the GAO is conducting a survey of FADA, and we welcome such inquiry. In addition, audits for federal savings and loan associations are required under Bank Board regulations (12 CFR 563.17-1(a) (2)). Pursuant to that federal regulation the national accounting firm of Peat Marwick and Mitchel has been engaged to conduct audits of FADA. In addition, the Bank Board and FSLIC conduct examinations and audits of FADA in accordance with federal regulations.

V. <u>CONCLUSION</u>

The FSLIC fund now has a much lower ratio of reserves to deposits than the Ohio and Maryland funds had immediately prior to their collapse. Without recapitalization, the FSLIC fund will continue to decline. All of us are aware of the terrible price inflicted on depositors, commerce and taxpayers by the Ohio and Maryland thrift failures. Those failures also created political crises that still reverberate in both states. We can avoid that calamity if we act responsibly and decisively now to put the FSLIC-Treasury recapitalization plan into operation. Those who would engage in continued brinksmanship with the solvency of the FSLIC fund are risking disaster.

Additional Material Submitted for the Record

OFFICE OF REGULATORY POLICY, OVERSIGHT, AND SUPERVISION

MISSION STATEMENT

The Office of Regulatory Policy, Oversight, and Supervision ("ORPOS") assists the Federal Home Loan Bank Board ("Board") and the Federal Home Loan Bank System ("System") in carrying out the mission of fostering a safe and sound savings institutions ("thrift") industry.

ORPOS is the focal point for governing and directing, on behalf of the Board, the ongoing examination, supervision, and case processing of thrift institutions by the Board's Principal Supervisory Agents in the twelve Federal Home Loan Bank districts. In this capacity, the Office is responsible for overseeing, influencing, and improving regulatory, examination, and supervisory functions. Reporting directly to the Board, ORPOS is responsible for promulgating fair and consistent national standards in the areas of examination and supervision. ORPOS is also responsible for monitoring the Banks' adherence to the standards and their effectiveness in carrying out examination and supervision functions. Any regional regulatory, case processing, examination, and supervisory differences are identified and resolved by ORPOS.

ORPOS, with a unique perspective over the entire System, provides the Board with policy initiatives and offers expert advice in the formulation and development of regulatory and supervisory policy.

ORPOS is responsible for the identification of issues presenting systemic risk and the formulation of policy initiatives responsive to such risks. ORPOS coordinates the implementation of Board policy through the System by providing appropriate guidance and interpretation to the Banks, Board agents, and regulated institutions.

ORPOS serves the System with expertise and information in a variety of disciplines to enhance effective performance of the System's regulatory functions. ORPOS interprets and communicates the field's policy development input and views on regulatory issues to the Board and communicates Board policy to the System. Finally, ORPOS serves as a facilitator of new ideas, concepts, and technological innovation for the Board and the System.

II. EXAMINATION AND SUPERVISION ACTIVITIES

A. Improvements in the examination and supervisory process and transfer of functions to the Federal Home Loan Banks (FHLBanks)

The severe financial crisis that has plagued the thrift industry over the past several years took its toll on the Board's capacity to examine and supervise the institutions under its jurisdiction. During this time, we frequently had to use our limited resources to handle only critical situations, rather than to engage in systematic, well-designed examination and supervision aimed at preserving the health of FSLIC-insured institutions. This situation, if allowed to continue, could have destroyed our ability to protect the safety and soundness of the thrift industry. Therefore, the Board has taken positive and aggressive action to strengthen its examination and supervisory efforts.

As of July 6, 1985, the Board transferred its field examination function to the FHLBanks. This historic move enabled us to pursue, with all deliberate speed, the process of building a well-trained, effective, and efficient field examination force. By December 31, 1985, the number of professional examiners on the staffs of the FHLBanks grew from 747 to 1,003, an increase of 34.3 percent. As I stated in my testimony last year, the Board established a goal of at least 1,500 examiners for the FHLBanks by the end of 1986. I am pleased to report that there were 1,524 professional examiners on board as of December 31, 1986. This brings the total increase to 777, or 104.0 percent of the staffing levels as of the date the functions were transferred. Of this increase, 376 or 48.4 percent, were in the Atlanta, Dallas and San Francisco districts, where many of the most serious industry problems exist. The flexibility afforded by the transfer of the examination function to the FHLBanks also has resulted in hiring a substantial number of additional examiners chosen from among far better qualified candidates than was previously possible. Many have attained advanced degrees and/or professional designations, such as Certified Public Accountant.

The supervisory staffs in the FHLBanks have also been commensurately strengthened. The professional supervisory staffing levels were increased by 62.2 percent to 550 nationwide during calendar year 1986. Training of both examination and supervisory personnel was conducted at an all-time high level during 1986. I am pleased with the progress we have achieved. However, more needs to be done and will be done, to add to the quality and quantity of our examination and supervision efforts in the FHLBanks.

B. Creation of the Office of Regulatory Policy, Oversight and Supervision

The Office of Examinations and Supervision (OES) has always performed a pivotal role in the Board's examination and supervision of insured institutions. This office has been responsible for recommending and implementing Board policy on application and case processing, monitoring and system maintenance, and post-audit review of delegated authorities. During the past several years, numerous factors, including deregulation and the declining financial health of the thrift industry, have coalesced to raise the demand for a stronger examination and supervision function.

In the wake of the transfer of the field examination functions from the OES to the FHLBanks, the Board decided to reevaluate the role of the OES. A task force, chaired by former Board Member Hovde and made up of representatives of the Board and the FHLBanks, was established to conduct this study. On March 12, 1986, the task force recommended that the Board transfer the remaining functions of OES from under the aegis of the Board to a position within the FHLBank System.

After careful consideration of the recommendations of the Task Force and of staff, the Board determined that its purpose of improving the effectiveness of its examination and supervisory functions would be best served by establishing within the FHLBank System a new Office of Regulatory Policy, Oversight and Supervision (ORPOS) through which to exercise its statutory responsibility to oversee, control, and, where necessary, improve those functions. On July 24, 1986, the Board voted to establish ORPOS, and this was done effective September 27, 1986. The establishment of ORPOS followed as a natural conclusion to the transfer of the examination staff to the FHLBanks. Basic to this determination was the Board's finding that such restructuring would give it the managerial flexibility it urgently needed to respond more successfully to the complex challenges posed by thrift industry conditions. To take advantage of the economics and efficiencies of combined operations, ORPOS shares, to the extent practicable, accounting, budgeting, payroll, personnel, and other administrative services with the FHLBank's Office of Finance. ORPOS is charged with the responsibility of advising and assisting the Principal Supervisory Agents (PSAs) of each FHLBank with respect to the activities of officers or employees of the FHLBanks as agents of the Board and the FSLIC. It assists in the processes of examination and supervision and advises as to any necessary or appropriate improvement or standardization. ORPOS advises and assists the PSAs and Board with respect to matters of policy, legislation, or regulation relating to its functions as the Board requests. Moreover, ORPOS performs for the Board any monitoring, evaluation, post-audit review, processing of applications, or other functions deemed necessary or appropriate by the Board to ensure the integrity and efficiency of the examination and supervisory functions. In addition, the new office succeeds to any delegation of authority by the Board to the former OES or its Director or employees, and ORPOS peforms any duties arising from such delegation and succession.

To assure that ORPOS can most effectively carry out its mandated responsibilities, the Director of ORPOS reports solely to the Board. There are no intermediaries or committees of any type interrupting that direct line of authority and responsibility. While the operation is funded through assessments levied upon the FHLBanks, the budget, assessments, staffing levels and all operational matters are decided by the Board. In this manner, the Board has assured that there will be no compromise of its statutory responsibilities and authorities.

A system of operational audits of the FHLBanks will be established by ORPOS. It is anticipated that such audits will be conducted for each FHLBank at least every two years. The findings of the audit teams will be reviewed by ORPOS which will then prepare summary and exception reports for the Board. The audit team leaders will conduct follow-up reviews to assure that the FHLBanks are taking appropriate corrective actions on problems noted.

The audit review will serve to identify problems in the examination and supervisory function of each FHLBank. In addition, monthly reports of results will be submitted by the FHLBanks on examination cycles, including frequency and timeliness of regular examinations, length of time spent examining institutions, number and type of special examinations, and timeliness of supervisory actions. The review will also focus on compliance with net worth, growth and direct investment regulations, and related actions taken by the supervisory agents. Finally, FSLIC related matters, such as the MCP, will be reviewed.

C. Computer-Assisted Examination and Supervision Process

Early in 1987, the Board implemented a major improvement to the examination and supervision through the introduction of the computer. In development for one year, this project constituted a major investment by the Bank Board and the Federal Home Loan Bank System in computer hardware and software as well as staff resources to achieve a major enhancement of the examination and supervision functions, as well as integration of these two functions.

The changes included introduction of three new systems. The Report of Examination System is designed to capture the report of examination on-line for later retrieval and analysis. Examination teams in the field are now provided with personal computers in order to conduct an examination. An electronic pre-formatted blank report of examination is provided to each examination team on the personal computer for use in preparing the report. When completed, the report is retained in Washington on-line.

<u>The Examination Data System</u> captures on-line supplemental information developed during an examination which has been previously retained in workpapers. This information is also input into the personal computer at the examination site, and is subsequently forwarded electronically to Washington for later retrieval and analysis. The <u>Supervisory Action Control System</u> captures data regarding the issues or problems facing insured institutions and the actions which supervision in a Federal Home Loan Bank may take to address these problems. The issues included in the system include automatically problems reported in examination reports.

Implementation of these systems included a major commitment of time, money and personnel in the Federal Home Loan Bank System and the Bank Board. As a result, however, the Federal Home Loan Bank System has achieved major enhancements in its examination and supervision processes. The first major outcome was development of a standardized format for the Report of Examination. As part of the Report of Examination System, there is maintained on the mainframe a current version of the Report of Examination format a copy of which is then transferred to the on-site examiner for his or her use in preparing the report of examination. The Bank Board believes that use of a consistent and uniform report format will make the examination report, as the principal product of the examination process, a more useful and effective tool in the Board's regulatory function. All readers of the report throughout the Bank Board and the Bank System will be able to anticipate where major comments and other features of the report will be presented.

A second major outcome of these changes is to accelerate and broaden the availability of the examination report document. The Board believes that the report findings will be more meaningful and have greater effect if made available more immediately and widely to those within the agency with a need for access to the document.

A final major outcome of these changes is to increase the quality of information available on-line through the system to analysts. This includes, on the examination side, information previously retained in workpaper files. On the supervision side, this includes key information regarding actions taken to address key supervisory issues.

D. <u>Accounting Issues</u>

Significant accounting issues involving the thrift industry continue to emerge at an ever increasing rate. During 1986 the Financial Accounting Standards Board (FASB) issued a final statement on loan origination and commitment fees and an exposure draft for public comment on accounting for income taxes. Both issues have widespread effect to our industry.

Due in a large part to valuable input during the comment period from our industry, the Bank Board staff and the Bank System, the final FASB statement on loan origination and commitment fees is much more fair and meaningful to our industry than the original exposure draft issued in December 1985. The statement calls for, among other things, the deferral and amortization of origination fees and the capitalization of related costs of the origination process. The effective date of the statement is for years beginning after December 15, 1987 and retroactive application is allowed but not required.

The Exposure Draft entitled Accounting for Income Taxes which was issued in September 1986, contains a provision which could reduce the net worth of our industry by approximately $4 billion. This proposal would require a retroactive and continued booking of a tax liability on taxes currently excused by the IRS for bad debt deductions. The Bank Board issued a response to the exposure draft that took a strong stance against this provision. Most other organizations that responded to this provision took a similar view to our response. The FASB will evaluate these comments and plans to issue a final statement during the third quarter of 1987.

Additionally, the FASB has undertaken a multi-phased long term project on financial instruments. This project, which is the largest and most far reaching that the FASB has ever attempted, was prompted by concern over the plethora of accounting issues concerning financial institutions and financial instruments. The final product of this undertaking will form the accounting and reporting model for all financial institutions in the future. The board staff has been an active participant in the development phase of this project and has been asked by the FASB to be part of the task force developing this project.

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JAN 13 1987

TOM S. KING
Executive Vice President

TEXAS SAVINGS & LOAN LEAGUE • 408 W. 14TH ST. • AUSTIN, TEXAS 78701 • 512/476-6131

January 9, 1986

The Honorable Fernand J. St Germain
House of Representatives
Washington, D.C. 20515

Dear Congressman St Germain:

Enclosed for your information is a "Blueprint for Action" of the Texas Savings & Loan League.

Your consideration will be deeply appreciated.

Sincerely,

Tom S. King
Executive Vice President

TSK/lmm

TOM S. KING
Executive Vice President

TEXAS SAVINGS & LOAN LEAGUE • 408 W. 14TH ST. • AUSTIN, TEXAS 78701 • 512/476-6131

December 29, 1986

BLUEPRINT FOR ACTION

RESTORING THE HEALTH
OF THE
SAVINGS & LOAN BUSINESS IN TEXAS

Of all the different financial institutions operating in this state, the savings and loan association has traditionally and consistently been at the forefront of service to its community through the promotion of thrift and home ownership and by meeting the needs of its customer base. The problems currently besetting the thrift industry have been all too well documented on the front pages of the major newspapers and in articles chronicling the ills of the industry. The time has come to focus our energies and efforts on finding positive solutions to restore the health of the savings and loan business.

Indeed, the problems are complex and solutions elusive. The savings and loan industry did not suddenly awaken one morning confronted by its current situation. Neither will it extricate itself overnight. But with enlightened long-term planning and faithful execution, there is every reason to believe the industry can emerge stronger and make greater contributions to the business economy of this state than ever before.
Below is an outline of steps that should be followed if the industry is to survive while it is returning to vitality:

I. FEDERAL HOME LOAN BANK BOARD ACTIONS

A. Change the Federal 100% Loan-To-Value Regulation. Direct investments have been portrayed as the proximate cause of FSLIC's major problems. The question should be asked "Why did the perpetrators of these atrocities use the ADC loan vehicle rather than make a direct investment?" As a direct investment, only costs can be recorded on the association's books. Instead, the "players" used Federal Regulation Sec. 545.32(d) which specifically authorizes a loan of 100% of the appraised market value of the collateral. This device allowed unscrupulous developers and/or associations to build in practically any amount of funny money necessary to carry out their devious intentions. Rather than rail against direct investments, the regulation on 100% loans-to-appraised-value should be changed to "100% of appraised value or cost, whichever is less." This would prevent, as well as any regulation can, ADC or any other real estate loans from being used by manipulators to FSLIC's detriment. This change would also go a long way in limiting the loans to one borrower and, in fact, may even eliminate the need for a restriction on loans to one borrower.

B. Adopt FASB 15 Immediately. The industry has suffered a deterioration in the quality of its real estate asset portfolios in recent months due to falling real estate values and regulatory reclassifications. If associations are forced to recognize the entirety of their losses in the accounting period in which their assets are reclassified, the strain on their collective net worths will be unbearable. FASB 15 provides a vehicle to allow the association to avoid loan loss recognition where severe economic conditions jeopardize the borrower's ability to repay, thereby allowing time for restructuring and workouts to salvage the value inherent in these assets.

FASB 15 will not fit all the cases of potential real estate losses an association may encounter. It may become necessary for federal regulators, after FASB 15 has been applied, to allow associations to set up additional losses that can be written off over 20 years, similar to what the office of the Comptroller of the Currency does for agriculture lending banks.

C. Mitigate the Effect of the Reclassification of Assets Regulation. For those cooperative associations with proven records of performance and sound business plans for working out their problem loans, the Reclassification of Assets Reg should be applied with discretion. This Reg, injudiciously used, has the potential to destroy the net worths of virtually every S&L in Texas. At a time when the net worth of the industry is at an all-time low, further regulatory raids on assets are totally inappropriate. This is especially true when R-41c is used at time of foreclosure. Forcing an R-41c appraisal at that particular time assures necessary write-offs that could destroy associations.

D. Encourage Workouts Between Cooperative Institutions and Quality Borrowers. District supervisory agents should be encouraged to promote the restructuring of loans whenever possible to tailor the rates and terms to better fit realistic current cash flows. Cooperation between an association and a motivated borrower doing his best to make a project profitable is a far better alternative to foreclosure and subsequent dumping of the collateral on an already saturated real estate market.

E. Expedite Regulatory Decisions on Business Plans and Workout Programs. When Associations submit business plans and workout programs to district supervisory agents, they have a right to expect answers within a reasonable time. District supervisory agents should be instructed to act as expeditiously as possible to get the answers these associations need to enable them to go about the business of solving their problems. Undue delay in this process only brings about stagnation in these projects and results in further depression of their value.

F. Support and Indemnify New Management. In some institutions management changes have been and will be deemed necessary by regulatory authorities. It is absolutely essential that the management teams brought in to oversee these institutions and work out their problems be given complete freedom to operate -- free from the spectre of lawsuits and losses resulting from making the difficult decisions they are forced to make.

G. Cooperate with the State Savings and Loan Commissioner. Over 200 of the 275 Texas S&Ls are state chartered. The state commissioner has ongoing supervisory authority over these institutions and has, in many cases, a better and more complete knowledge of the activities and affairs of the associations. The exchange of information, including examinations data, could help both the regulators and the institutions. In problem cases, timely, decisive action by both regulators acting in concert could often lead to solving problems while they are still of manageable size and nature. Delays only exacerbate the problems.

I. MANAGEMENT OF FSLIC PROPERTIES

The S&LS and others involved in the real estate business are concerned about the way the FSLIC manages the properties it has acquired and will acquire from insolvent institutions. The possible "dumping" of these properties at fire sale prices will serve only to further intensify the already substantial downward pressure on real estate values in Texas. The potential for mismanagement stems primarily from three problem areas:

A. Transferring Properties Directly from FSLIC to Liquidators. In times past, when problem S&Ls were rare and the economy in general was stronger, the direct transfer of properties from FSLIC to liquidators caused few problems. Now, however, this direct transfer greatly increases the likelihood that these properties will be dumped on the Texas market. The typical liquidation contract calls for management fees of one-half to one percent and disposition fees of up to three percent. A discounted cash flow analysis quickly reveals that the real payoff to a liquidator comes not from management but on disposition of the property. There is little emphasis on maximizing the price. Further, the FSLIC's expertise does not lie in real estate management, resulting in an employer who, by background and experience, is unqualified to adequately monitor the process.

B. Managing FSLIC Properties from a Global Perspective. The decision as to whether a property should be sold or managed into a better economy needs to be made from a global perspective by an entity possessing an overview of FSLIC's entire holdings in a particular state or region. It is impossible to expect a favorable outcome, if these decisions are allowed to be made independently by a diverse group of managers/liquidators, regardless of how knowledgeable and well-intentioned they might be. They simply are not read into the "big picture" of the total FSLIC holdings in any one state or region.

C. Utilizing Specialized Subcontractors. Turning over the entire portfolio of an insolvent institution to one manager/liquidator will not maximize the dollars to be derived out of these assets. Different subcontractors have different types of expertise: apartments, strip centers, leasing capabilities, etc. Expecting any one subcontractor to do a first-class job on a diversified portfolio of investments is unrealistic. To maximize the return on these assets, they should be grouped by type and matched with subcontractors possessing the appropriate expertise.

D. Conclusion. For the reasons stated above, FADA should be utilized to the full extent of the powers granted in its charter and should receive all properties that come into the possession of FSLIC for direction and dissolution.

III. MANAGING REO INTO A BETTER ECONOMY

The Texas savings and loan industry believes that a method or methods should be developed to hold real estate until the economy improves and absorption rates return to normal.. By allowing associations to use these innovative governmental and/or private sector vehicles to hold real estate, FSLIC would benefit by not having to take over associations they otherwise would. While we are listing only four possibilities, the American system can surely come up with many more when we put our minds to work on this problem area.

A. SuperFederal. Each District bank could charter a Federal savings and loan association for the sole purpose of acquiring real estate from S&Ls in exchange for a 1% cash user's fee and the giving of ten year zero-coupon bonds. The SuperFederal association could then assign to willing developers these properties for development, with the developer assuming all carrying costs except interest on the real estate (said interest deferred until final sale and close out of project). If the property cannot be profitably sold within the ten year period, the original association would then take the loss. This gives at least a ten year holding period for improvements in market to occur.

B. Publicly Held REITs. Real estate could be accumulated from among several savings and loans and placed in a public offering by an REIT. The REIT would hold these properties for appreciation over a number of years. The participating S&Ls would then be free to restructure their assets and net worth without the encumbrance of problem real estate.

C. Multiple Limited Partnerships. Much like a publicly held REIT, limited partnerships could be sold to the public as a vehicle to hold real estate until values and absorption rates improve.

D. National Asset Exchange Corporation. A method whereby an association can exchange senior preferred stock in an insurance company for real estate. The preferred stock would yield approximately 7% with a ten year amortization.

IV. CONGRESSIONAL PARTICIPATION

A. Close the Non-Bank Bank Loophole. The simplest and most direct way to infuse capital into the Texas industry and take some of the pressure off the FSLIC is through the purchase of troubled Texas S&Ls by out-of-state entities. The recent acquisition of Texas Commerce BancShares by Chemical Bank of New York evidences the almost universal desire of out-of-state institutions to gain entry into the Texas market. It is totally impractical to suppose that Texas institutions are going to buy troubled Texas thrifts; they are already in this market. Similarly, it is totally impractical to suppose that if an out-of-state institution can gain entry into Texas through the chartering of a de novo non-bank bank, it will nevertheless pay a premium for a troubled Texas thrift. The non-bank bank loophole must be closed for a period of two to three years to force those out-of-state institutions desiring entry into the Texas market to buy their way in. The most important vehicle to attract purchase of these S&L charters is to maintain the ability of the unitary holding company with tandem operations to survive any further restrictions. Additionally, there should not be enacted any restrictions on commercial companies from owning an S&L Charter.

B. Recapitalize the FSLIC Early in 1987. In order to reinforce public confidence in the FSLIC, and indeed in the entire S&L industry, recapitalization of the FSLIC should receive the highest priority when Congress reconvenes in January. Regardless of the methodology used, there are critical issues surrounding FSLIC recapitalization. If a large, one-time infusion of capital is deemed appropriate, its disbursement should be in controlled allocations. The expenditure of two to three billion dollars per year may very well saturate FSLIC's ability to manage the assets it will acquire as a result of the expenditure of these funds. A vehicle can be created which will allow this annual limit to be increased in the event of emergency. Legislation to recapitalize the FSLIC should contain language eliminating the one-eighth percent special premium assessment, possibly phasing it out over a five-year period. The net worth of the industry is already strained to capacity and its further erosion is unconscionable. If the industry is to weather the current crisis and regain its viability, it must be allowed to retain its capital in order to promote healthy growth.

C. Net Worth Certificates should be Reenacted. The net worth certificate program worked in New York several years ago. New York savings institutions were in great difficulty, but with the aid of the net worth certificates program plus time and hard work, they are thriving institutions today.

The savings and loan business in Texas is in the midst of a storm of violent proportions. It has weathered storms before, and with the resiliency born of years of experience in the Texas economy and years of service to Texas communities and customers, the savings and loan business will weather this storm. The road ahead will not be an easy one but following the steps outlined above can lead to a full and complete recovery.

AUBREY G. LANSTON & CO. INC.

SPECIALISTS IN
UNITED STATES GOVERNMENT
AND
FEDERAL AGENCY SECURITIES

NEW YORK • CHICAGO • BOSTON

David M. Jones
Senior Vice President and Economist

Twenty Broad Street
New York, N.Y. 10005
212-943-1200

May 13, 1986

The Honorable Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mr. Gray:

Please allow me to offer my support of your FSLIC Recapitalization Plan. It is a carefully crafted plan that offers the best prospect for bringing the FSLIC back to a firm financial foundation.

One key aspect of this plan is that the premium of 1/8%, which is currently being levied on the savings and loan industry, will continue to be assessed. This will be done to the extent it is required to augment other FSLIC income in order to insure the servicing of the debt of the new Financing Corporation. The retention of this special premium is absolutely essential to the success of the debt offerings of the Financing Corporation. It gives market investors contemplating purchase of the debt confidence that there will be sufficient funds available from FSLIC sources to adequately service this debt.

The important point to underscore is that this FSLIC Recapitalization Plan should be incorporated as a complete package. As a whole, it promises to do the job; but this means keep all its components intact, including the important 1/8% special premium.

Sincerely,

David M. Jones

DMJ:cp

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10 HANOVER SQUARE
NEW YORK, N.Y. 10005

Bernard C. Grigsby II
VICE PRESIDENT

May 13, 1986

The Honorable Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G. Street NW
Washington, D.C. 20552

Dear Mr. Gray:

We are concerned about proposed federal legislation which would phase out the F.S.L.I.C. special insurance premium assessment of 1/8%.

The F.H.L.B. plan for the recapitalization of F.S.L.I.C. includes the chartering of a F.S.L.I.C. Financing Corporation. Under the plan the Financing Corporation would sell to the public sizable amounts of debt securities to provide funds to strengthen F.S.L.I.C. It is contemplated that debt service on these securities would be paid from resources available to F.S.L.I.C. including the 1/8% special assessment. A phase out of this important source of F.S.L.I.C. revenue would very adversely affect the Financing Corporation's ability to sell its securities in the public market.

We would urge the Congress to retain the 1/8% special assessment as an integral part of the F.S.L.I.C. recapitalization plan.

Sincerely,

B. C. Grigsby II

BCG/cmc

BEAR STEARNS

May 14, 1986

Mr. Edwin J. Gray, Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mr. Gray:

A bill is being introduced in Congress which would place a five year limitation on the authorization for the special premium assessment of 1/8% of total deposits of the thrift institutions whose deposits are covered by FSLIC insurance.

We believe that it is in the best interests of the thrift industry that this authorization be maintained indefinitely.

Under the proposed recapitalization plan for FSLIC, the regular premuim assessment of 1/12% and the special assessment of 1/8% are to be used for servicing the debt instruments to be issued by the new FSLIC Funding Corporation. Although it is planned that the special assessment is to decline linearly and be removed after the year 1991, the fact that authorization for the special assessment remains will instill confidence in the investment community. This confidence is vital to the successful marketing of the Funding Corporation debt on the most advantageous terms.

The Funding Corporation will be borrowing for terms of twenty to thirty years. It is impossible to look that far into the future. Hopefully, no additional revenues will be necessary to service the debt after 1991, but the authorization for the special premium assessment should be maintained as a safeguard. This will greatly enhance the quality of the debt instruments issued by FSLIC Funding Corporation and result in cheaper borrowing costs.

Very truly yours,

Alan C Greenberg

Alan C. Greenberg

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Atlanta/Boston/Chicago/Dallas/Los Angeles/New York/San Francisco
Amsterdam/Geneva/Hong Kong/London/Paris

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Jon S. Corzine
Partner
U.S. Government Trading

May 13, 1986

Mr. Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G Street NW
Washington, D.C. 20552

Dear Mr. Gray:

I understand that there is a movement underway to eliminate the 1/8 of 1% "special" premium assessed by the FSLIC on savings and loan deposits. It is my strong belief that the existence of this premium, which would be used to support debt service on obligations of the proposed FSLIC Financing Corporation, is absolutely essential to the successful, cost-effective marketing of FFC debt securities.

I believe that investors will view the availability of the special FSLIC assessment as an important cushion against unexpected negative cash flow developments, and therefore that its elimination would make investors unwilling to purchase FFC securities unless they carried very significant yield premiums over Treasury and other agency securities.

The FSLIC recapitalization proposal submitted by the Federal Home Loan Banks provides for retention of the special premium with a gradual phase-out over a five-year period, dependent on the FSLIC's ability to make interest payments on FFC debt without these additional funds. I support this plan, as I feel that the continued existence of the special premium would greatly enhance the market's assessment of the FFC's credit quality and would therefore lower the prospective agency's financing costs.

Sincerely,

Jon S. Corzine

DEAN WITTER REYNOLDS INC.
130 Liberty Street, New York, NY 10006
Telephone (212) 524-2222

May 14, 1986

The Honorable Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 9th Street N.W.
Washington, D.C. 20552

Dear Mr. Chairman:

On behalf of my colleagues here at Dean Witter, I would like to express my appreciation to you and all your staff for the informative meeting at the New York Fed last week. We are very much aware of the Savings and Loan industry's efforts to provide stability to its various members and the role of FSLIC as well.

We believe the Recapitalization Plan presented to us is sound and timely, especially as far as the capital markets borrowing component is concerned.

My whole career has been spent either in the U.S. government market, or closely associated with the market. I began my career as a trader of Federal Agency obligations at Chase Manhattan and then performed the same function for Goldman Sachs. In 1975, I was appointed Deputy Fiscal Agent for Fannie Mae, where I spent ten years marketing that Agency's debt. I have experienced periods of ease as well as extreme difficulty in marketing Agency debt.

Fortunately, we are experiencing a period that is generally friendly to Agency issuers and particularly in longer maturities. Historically, as you know, there has been fairly limited capacity for the market to absorb new issue Agencies. That was primarily due to the heavy concentration of commercial banks as Agency investors and their basic reluctance to invest beyond the intermediate range. Another reason, of course, is the enormous liquidity in longer dated U.S. Treasuries, a luxury not shared by Agencies.

Recently, however, Agencies have been able to borrow in longer maturities, largely because of the emergence of foreign (mostly Japanese) investors, who are more interested in yield and quality then in liquidity. I believe the decision to utilize the longer market is sound and opportunistic.

There are several observations that I would offer with regard to the proposal, however. First, the instrument and instrumentality are new and will require some education and marketing. Second, the FSLIC Financing Corporation will be scrutinized simply because it is a new entity, but achieving Agency status through its association with the FHLB will probably eliminate most uncertainty. Next, the selling group, with its basic familiar structure, should lend itself well to the issuance of the debt. Finally, the structure for suppporting the debt service is sound and should allay most concern about the viability of the instrument.

It is this last point which has prompted my letter to you. While we believe the structure to be sound, this structure is essential. We are somewhat concerned about comments we have heard with regard to the elimination of the premium surcharge which the Board may levy over and above the normal 1/12 of 1% FSLIC premium.

We believe that the revenue generated by the normal premium and the surcharge provide comfort to investors insofar as the Financing Corporation's ability to meet its debt service requirement. In fact, it is essential that this program which will be of enormous benefit to the industry, be successful. I mentioned earlier about the generally negative historical experience of Agencies in the longer market. Every effort must be made to support the marketing of this debt and that surcharge is essential.

Please accept this letter in the spirit of cooparation und support that we feel for the Bank Board.

If I may amplify on these comments or be of any assistance, I am at your disposal. Please accept my thanks for your indulgence.

Sincerely,

John J. Meehan
Senior Vice President
Government Bond Dept., Manager

JJM:df

cc: Austin C. Dowling

Subsidiary of
Irving Trust

Irving Securities

Mead L. Briggs
Senior Executive Vice President

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Briggs Schaedle Division
One Wall Street
New York, NY 10015
212 635 1230

Mr. Edwin J. Gray, Chairman
Federal Home Loan Bank Board
1700 G. Street N.W.
Washington, DC 20552

May 13, 1986

Dear Mr. Gray,

Several members of Irving Securities Inc. including myself attended the May 8, 1986 presentation of the FSLIC Recapitalization Plan. We found the preliminary information well-presented and the question and answer period that followed was well-addressed.

I have been personally involved in the Federal Agency market for the past nineteen years. In my preliminary opinion the FSLIC could issue debt based on the information as presented. There are two key attributes which would make these securities viable to the investing community. First, the principal would be preserved through economic defeasance. Second, the interest payments would be backed primarily through the collection of one-twelfth of one percent premium, plus the assessment of one-eighth of one percent special premium. Given the assumption at the presentation the special premium would be phased out over a 5-year period to enable the savings and loan industry to be competitive with the commercial banking industry. If this special premium were legislated to expire in five years, the safety of the cash flow to cover interest payments would be called into question. The investor would question the cash flow if, for some reason, the assumptions given at the presentation turned out to be too optimistic. I feel legislative action on the special premium reduction would significantly add to the cost of borrowing or, at worst, require some type of government support to offset the added risk in the determination of the investor.

These thoughts are my personal opinion based on the overview presented on May 8, 1986 and my nineteen-year involvement in the Federal Agency market. If you have any questions, I would be pleased to discuss the matter further at your convenience.

Sincerely,

Bankers Trust Company
One Bankers Trust Plaza, New York, New York 10015

Allan W. Rogers
Senior Vice President
Telephone: 212-775-4648

May 14, 1986

Mr. Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G. Street NW
Washington, DC 20552

Dear Chairman Gray,

In my estimation, the FSLIC recapitalization proposal, set forth by the Federal Home Loan Bank Board on 8 May 1986 contains a number of key components which will assure the viability of the plan and provide the highest degree of acceptance in the financial market.

First, the Financing Corporation will be sanctioned by Congress. Second, all principal repayments on Funding Corporation debt will be assured through defeasance. Third, debt service will be assured by FSLIC's premium income and the ability to employ a special assessment on thrifts if the standard premium income proves insufficient to service the debt. As a result of these three features investors will in essence have an obligation from the government entity (FSLIC) of both principal and interest.

Because of the defeasance of principal it is the assurance of interest which becomes the most important concern for investors. If the ability to assess the special premium of 1/8% is repealed it will jeopardize the viability of the entire recapitalization.

I urge strongly that the current proposal as stated on May 8th remain intact, particularly the features which assure repayment of principal and interest.

Sincerely,

Allan W Rogers

BankAmerica
Capital Markets Group

Leon A. Wistrak
Senior Vice President
and Executive Officer

Bank Investment Securities Division

May 14, 1986

The Honorable Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G Street N.W.
Washington, DC 20552

Dear Mr. Gray:

Bank of America supports legislation providing for the recapitalization of the savings and loan industry through the establishment of the FSLIC Financing Corporation. We agree that the Financing Corporation is needed to restore financial integrity to the industry as outlined in the FSLIC Recapitalization Plan and presented at the Federal Reserve Bank of New York on May 8, 1986 for the FHLB Selling Group members.

In our capacity as a Selling Group member we have reviewed the plan and have concerns about one of its major conditions. As part of the proposal to fund the FSLIC Financing Corporation, the additional 1/8% premium which is being charged to member institutions is anticipated to be phased out in 1991. If this phaseout were mandatory, the Financing Corporation's ability to raise necessary capital in the debt markets and achieve the desired financial stability in the industry may be impaired.

Conditions attached to the 1/8% premium may create uncertainty regarding debt service in the minds of investors who may be reluctant to buy obligations of the FSLIC Financing Corporation, or might create greater interest rate spreads that would in turn increase the funding costs to the FSLIC. These funding costs would be higher than those currently enjoyed by other Federal Agencies.

It is for these reasons that we question any mandatory elimination of the 1/8% premium assessment.

Sincerely,

Leon Wistrak

Bank of America Center   Box 37003   San Francisco, California 94137

FIRST CHICAGO
The First National Bank of Chicago

One First National Plaza
Chicago, Illinois 60670
Telephone: (312) 732-8380

G. Edward Means
Senior Vice President

May 15, 1986

Federal Home Loan Bank Board
1700 G Street, N. W.
Washington, D. C. 20552

Attention: The Honorable Edwin J. Gray, Chairman

Dear Mr. Gray:

In reviewing the proposed recapitalization plan for the FSLIC, it is our opinion that the structure, as outlined, is viable and would be well received by our customer base.

It has come to our attention, however, that there is some discussion as to the necessity of retaining the 1/8th percent special assessment as part of a legislative package. While we can understand the reasons for the savings and loan industry's request to have this provision removed, the inclusion of this premium is essential to the positive reception of the securities by investors. The back-up capability insuring a revenue stream to cover the interest payments on the debt should the FSLIC problems be more severe than currently anticipated, allows an important level of comfort to the investors. Therefore, we most strongly recommend that the 1/8th percent special assessment be kept as part of the proposed legislation.

Very truly yours,

G. Edward Means
Senior Vice President

GEM:jd

VIA FEDERAL EXPRESS

The Chase Manhattan Bank, N.A.
1 Chase Manhattan Plaza
New York, New York 10081
212 552 3854

Wolfgang Schoellkopf
Executive Vice President

CHASE

May 15, 1986

Mr. Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G Street Northwest
Washington, DC 20552

Dear Mr. Gray:

We at Chase Manhattan Bank, after careful consideration, would like to offer our support for your recapitalization plan for FSLIC. We agree that a strong initiative is needed to maintain the viability of FSLIC and to ensure the prolonged stability of their thrift system.

In our role as an underwriter, distributor and market maker of these new securities, we feel it is our responsibility to you and to the new entity to offer constructive advice regarding the structure of this new debt to ensure the best possible reception for this entity within the capital markets. In this regard, we support your proposal of maintaining the 1/8% special premium assessment to ensure, as a contingency, adequate reserves for debt service. This, we believe, will be integral to establish the proper levels of investor confidence and interest.

If we at Chase may be of additional assistance in this or any other matter, please feel free to contact us.

Sincerely,

W. Schoellkopf

THE NORTHERN TRUST COMPANY
FIFTY SOUTH LA SALLE STREET
CHICAGO, ILLINOIS 60675

TELEPHONE (312) [illegible]

LAWRENCE H. BROWN
SENIOR VICE PRESIDENT

May 15, 1986

Honorable Edwin J. Gray, Chairman
Federal Home Loan Bank Board
1700 G Street, N. W.
Washington, D. C. 20552

Dear Chairman Gray:

The Northern Trust Company has long been a member of the selling group which successfully distributes Federal Home Loan Banks securities.

We were represented at the May 8, 1986 presentation of the Federal Savings and Loan Insurance Corporation Recapitalization Plan and have carefully read the supporting documentation which details the proposed offering of bonds by the FSLIC Funding Corporation. We have great confidence in the strength of the FHLB system and support its efforts to assist the troubled FSLIC. In doing so, however, we believe that great care must be taken so that the investing public's perception of the FHLB system is not weakened. In this regard, we think it essential that the stream of revenues which are available to flow through FSLIC for backup debt service purposes in connection with the bonds be adequate to meet any contingencies. We are concerned by reports we hear that this stream of revenues may be diminished by the deletion of the special 1/8% assessement on total S&L deposits prior to its planned expiration. In our opinion, such a deletion, unless replaced by another identifiable source of funds, might well be perceived as materially diminishing the debt service coverage necessary to support the proposed bonds. Such an occurrence could make the marketing of the proposed bonds difficult, if not impossible to achieve.

We urge you to take whatever steps are necessary to maintain as strong a stream of funds as possible flowing through FSLIC to support the proposed bond issue and, thus, insulate as much as possible, in the eyes of the market place, FHLB from undue exposure.

Sincerely,

Lawrence H. Brown

Lawrence H. Brown

je

The Crocker Bank

Larry F. Clyde
Executive Vice President

May 15, 1986

The Honorable Edwin J. Gray
Chairman Fed Home Loan Bank Board
1700 G. St. N. W.
Washington, D. C. 20552

Dear Sir:

Through conversations with other selling group members of the FHLB System it has come to our attention that there is presently a move to eliminate the special 1/8% industry assessment as originally proposed in the May 6, 1986 Recapitalization Plan. We thought that you should be aware that market counterparts and clients with whom we have talked have expressed concern over the possible effects this action might have on the success of upcoming financings.

As a selling group member we also feels compelled to express our concern over the possible elimination of this assessment as we fear it could adversely affect the overall balance sheet of FSLIC and hence, the markets perception of the creditworthiness of FSLIC bonds. We feel that the appearance of the balance sheet will play a critical role in our ability to market paper effectively since it will be initial entry to the market.

As a member of the FHLB group we will do everything in our power to make this financing a success, but we would urge you to consider retaining the 1/8% assessment which will help insure the success of this new financing vehicle in the marketplace.

Yours very truly,

Larry F. Clyde

Crocker National Bank
Capital Markets Division
One Montgomery Street
West Tower, 25th Floor
San Francisco, CA 94104
(415) 983-2233

[illegible]

[illegible]

May [illegible], [illegible]

Mr. Edwin J. Gray
Chairman
Federal Home Loan Bank
1700 G Street Northwest
Washington, D.C. [illegible]

Dear Mr. Gray:

In connection with the 1/8% special premium currently charged the Savings and Loan Industry we believe its removal would make the Financing Corporation's issues less attractive to investors.

The authority to charge the special premium in our opinion strengthens investor confidence in the new FICO bonds. The premium also assures the servicing of the Financing Corporation's debt which would otherwise be a source of major concern to investors.

The only method of strengthening investor confidence and keeping yield spreads to other agencies and treasuries at a reasonable level would appear to be the retention of authority to continue charging the Savings and Loan Industry the special premium.

Sincerely,

[illegible]

RFP/sl

MAY 15, 1986

The proposed elimination of the FSLIC special insurance premium assessment of 1/8% currently under consideration by Congress would undermine seriously the FHLB plan for the recapitalization of the FSLIC. The plan would establish an FSLIC financing corporation that would distribute debt securities to raise additional financial resources for the FSLIC.

We feel that the ability of the financing corporation to market debt securities to the public would be impaired since debt service on these securities would be paid partially from this special assessment. We urge Congress to retain the 1/8% special assessment as a crucial feature of the FSLIC recapitalization plan.

Sincerely,

William M. Brachfeld
Executive Vice President
Daiwa Securities America Inc.

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

February 9, 1987

RECEIVED
FEB 12 1987
Subcommittee on Financial Institutions

Dear Mr. Chairman:

I am pleased to respond to your letter of January 28, 1987, regarding exit fees the FSLIC might charge thrifts changing to FDIC insurance and limits on direct investments made by state-chartered, FSLIC-insured institutions.

First, I should stress that an exit fee is not essential to the financial integrity of our FSLIC recapitalization plan. Our plan provides a number of cushions to ensure viability, including an interest reserve" of at least $800 million in the Financing Corporation (preserved from the original FHLBanks' investment). Also, Federal Home Loan Bank Board analyses have shown that at least 15% of the thrift industry's assets could leave the FSLIC while leaving it with positive reserves and without requiring any change in the phase-out of the special assessment.

However, we believe that Congressional interest in action on the exit fee issue is appropriate for several reasons. First, there is an equitable justification for charging S&L s leaving FSLIC a fee to compensate the insurance fund for inadequate payments in prior years. These S&Ls received nsurance coverage from a system that only now is paying the built-up costs of that insurance; t is only fair that these institutions pay a share of the costs accrued when they were FSLIC-insured Second, the industry the FHLBB, and the cap tal markets would benefit from an increased degree of certainty about the amount of an exit fee. Third an exit fee would reassure the S&L industry that the 1/8 of one percent special assessment can be reduced and eliminated on schedule and will not need to be reimposed. The second and third points also have the benefit of reducing uncertainty for investors considering putting capital into the industry which s an important approach to enhancing the industry's long-term strength.

Depending on one's view of the equities and the weight of the other two factors, the size of an exit fee that might be considered appropriate ranges from a low of 0.22% of deposits to a high of .30% of deposits The low fee would represent the present value of two years of the scheduled declining special assessment on a static deposit base, and excluding the regular 1/12% premium on the argument that another insurer will have to be paid the same amount. The high end would represent the present value of the remaining declining special assessment and ten years of regular premiums with both assessed on a growing insured deposit base. Values in between would depend on one's selection of time frame, deposit growth rate assumption, discount rate, and inclusion or exclusion of the regular premium In addition, we believe it would be appropriate, particularly for

higher levels of exit fees, for the exit fee to include a sliding scale that would be lower the later one left. Another item that would be equitable to include s the requirement that institutions which leave FSLIC should end their membership in the Home Loan Bank System (without affecting current FDIC members of the FHLBanks). It is our understanding that the FHLBB is work ng with the Committee on an exit fee amendment, and we encourage the Committee to give its full consideration to such an amendment.

With regard to the need for limits on direct investments made by state-chartered, FSLIC-insured inst tutions, we believe that t is appropriate and prudent for the Federal insurance fund to consider the risks to that fund created by such activities which is what the FHLBB is doing. The Bank Board held hearings on January 29 and 30 on this issue and will soon reach a decision.

We also believe that it s important for the FHLBB to retain the regulatory flexibility to tailor its responses to particular activities and particular institut ons on the basis of the risks and returns involved. In extreme cases it may wish to prohibit a risky activity. Alternatively t may set limits for all institutions, perhaps geared to capital levels or it may require closer supervisory scrutiny at certain levels of activity The crucial point is that the FHLBB should retain the ability to adjust its treatment of direct investments and other activities) depending on experience and individual conditions. As a result, we believe it would be unwise to impose a statutory rule that would limit the Bank Board's flexibility on this issue

Finally, we recognize that sharp divisions exist within Congress on this issue which may not be able to be reconciled. We urge Congress not to hold up the v tal recapital zation of FSLIC. Delay costs money, erodes confidence and weakens the protection of almost $900 billion of depositors funds The safest and most responsible course is to avoid unreconciled controversy and pass the FSLIC bill cleanly and quickly

We would be pleased to work with you and your staff on these issues.

Sincerely,

George D. Gould

The Honorable
Fernand J. St Germain
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D. C. 20515

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515

January 14, 1987

Honorable Edwin J. Gray, Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Chairman Gray:

As per staff discussions, the Committee requests your appearance at 10 a.m., on Thursday, January 22, 1987, in Room 2128 Rayburn House Office Building to testify on the provisions of H.R. 27, a copy of which is enclosed.

As was pointed out in my statement on the occasion of the introduction of H.R. 27, a copy of which is also enclosed, the only difference between the bill and that passed by the House last year is the provision relating to GAO audit authority which I understand has been brought to the attention of your staff.

It is also quite likely that the subject of direct investments will be raised since several members have indicated an interest in proposing amendatory language reflecting the considerable concern over the recent publicity surrounding activities of the Federal Home Loan Bank Board. Therefore I am extending invitations to witnesses who will reflect opposing views concerning this subject and believe it to be appropriate for you to be prepared to respond to questions concerning the subject or to advise the Committee of the Administration's formal position regarding the current Board regulation, now scheduled for an additional hearing on January 29 and 30.

In accordance with Committee rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building, Washington, D.C. 20515, 24 hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing records and, if delivered when requested, the statement will be made available to all Committee members in advance of the hearing. To provide all Committee members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to 10 minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:bSh

Enclosures

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515

January 14, 1987

Enclosed
HR 27 – Jan 6 Floor
Statement

The Honorable George Gould
Undersecretary for Finance
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Dear Mr. Gould:

As per staff discussions, the Committee requests your appearance at 10 a.m., on Thursday, January 22, 1987, in Room 2128 Rayburn House Office Building to testify on the provisions of H.R. 27, a copy of which is enclosed.

As was pointed out in my statement on the occasion of the introduction of H.R. 27, a copy of which is also enclosed, the only difference between the bill and that passed by the House last year is the provision relating to GAO audit authority which I understand has been brought to the attention of your staff.

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Sincerely,

Fernand J. St Germain
Chairman

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

EDWIN J. GRAY
CHAIRMAN

FEB 10 1987

RECEIVED
FEB 1 2 1987
Subcommittee on Financial Institutions

Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance & Urban Affairs
Rayburn House Office Building
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter of January 27, requesting information about the Federal Asset Disposition Agency and the FSLIC recapitalization plan.

As you know the Treasury - Bank Board recapitalization plan is based on very conservative assumptions regarding the costs of liquidations. It is assumed that liquidations will have a 40 percent to 42 percent net present value cost and that the funds from selling the firm's assets will be recovered over 5 years. FSLIC experience indicates liquidation costs are less than those incorporated into our plan. Therefore, the plan does not require that FADA be more successful in disposing of assets than FSLIC. If FADA is successful in its mission and causes liquidations to be less expensive, then less money would need to be borrowed and the FSLIC would be financially stronger than currently envisioned under the recapitalization plan.

The FADA will be evaluated through a multi-faceted process which will measure its performance with respect to its mission, its success in management and disposition of individual assets, and its operational integrity.

FADA's success in meeting its mission will be evaluated in terms of its business plan which details planned operations and provides pro-forma operating statements. FADA's business plan is updated regularly to reflect changing conditions and the uncertainties inherent in a new entity.

FADA's performance with respect to the assets it manages for the FSLIC is based on individual asset business plans prepared by FADA. The asset business plans, which must be approved by the FSLIC, detail recommended strategies for asset management and disposition, asset budgets, cash flows, net realizable value, and appraised fair market value for each asset. FADA's actual performance will be compared to the projections set out in the asset business plans.

I understand an examination of FADA by Bank Board examiners has been underway since mid-January.

Pursuant to regulations, FADA is subject to the audit requirements for federal savings and loans and has engaged the national accounting firm of Peat, Marwick and Mitchell to conduct audits of FADA.

FADA submits monthly operational reports to its Board of Directors, of which the Director the FSLIC is an ex-officio member. In addition, FSLIC is undergoing its annual audit by GAO. Since FADA is fully capitalized by the FSLIC we would have no objection to such GAO audits being extended to the FADA.

Mr. Chairman, the Treasury - Bank Board recapitalization plan is designed to be sufficiently robust that under most foreseeable circumstances it would provide security for the bond holders, adequate resources for the FSLIC to resolve its current and future cases efficiently and effectively, and allow for the timely phase out of the special assessment. However, there are circumstances under which the special assessment would have to be reinstituted. One scenario that would not permit the "phase out" of the special assessment would be a flight of 30 percent of the industry to FDIC and industry deposit growth dropping to 4 percent annually. Under this scenario the special assessment would have to be continued at 50 percent of the current level (1/16 of 1 percent) through 1996 to maintain debt service and sufficient funds at the FSLIC. Likewise, a revisiting of the high interest rates of 1979 - 1982 would result in high debt service costs and large additional numbers of thrifts failing. This would, without doubt, cause a continuation of the special assessment. Under a wide variety of reasonable scenarios, where the $800 million interest reserve is used as a cushion, the Treasury - Bank Board plan is extremely robust and the special assessment can be phased out, as planned.

Best regards,

Edwin J. Gray
Chairman

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515

January 28, 1987

Mr. George D. Gould
Undersecretary of Finance
Department of Treasury
1500 Pennsylvania Ave., N.W.
Washington, D.C. 20220

<u>Attention: Mr. Greg Wilson</u>

Dear Mr. Gould:

Thank you for your testimony at last week's hearing on the Federal Savings and Loan Insurance Corporation (FSLIC) recapitalization plan. In order to complete the hearing record, please provide written answers to the following questions:

1. Please articulate the Department of Treasury's position on an appropriate exit fee or penalty to thrift institutions that leave the FSLIC insurance fund to the FDIC at some time over the life of the recapitalization plan.

2. Please articulate the Department of Treasury and the Administration's position on the Federal Home Loan Bank Board's direct investment rule and proposals to modify that rule. Would the Treasury and the Administration support including a limitation on such direct investment in the FSLIC recapitalization plan? Please explain.

I would appreciate your response to these questions by February 9, 1987 as the Full Committee plans to mark up the FSLIC recapitalization plan in early February.

Again, thank you, and I look forward to your reply.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:aKk

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-NINTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515

January 27, 1987

Honorable Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Chairman Gray:

Thank you for your testimony at last week's hearing on the Federal Savings and Loan Insurance Corporation (FSLIC) recapitalization plan. In order to complete the hearing record please provide written answers to the following questions.

1. On page 25 of your testimony you mentioned the role of the Federal Asset Disposition Association (FADA) in dealing with troubled S&L real estate assets. Please provide the Committee with:

   1) FADA's projected income contribution to FSLIC over the life of the recapitalization plan and,

   2) the criteria and the means by which the Federal Home Loan Bank Board will evaluate whether or not FADA is a success or failure.

2. On page 15 of your testimony you stated that under your current assumptions, the special assessment "could" be phased out gradually over a five year period. Please state the scenarios, with as much specificity as possible, that would prohibit the FSLIC from phasing out the special assessment.

I would appreciate your response to these questions by February 9, 1987, as the Full Committee plans to mark up the FSLIC recapitalization plan in early February.

Again, thank you and I look forward to your reply.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:kTk